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TAX TREATIES WITH THE UNITED KINGDOM, THE REPUBLIC OF KOREA, AND THE REPUBLIC OF THE PHILIPPINES

DOCUMENTS

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HEARINGS

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS

UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

EX. K., 94TH CONG., 2D SESS., TAX CONVENTION WITH THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND; EX. P., 94TH CONG., 2D SESS., TAX CONVENTION WITH THE REPUBLIC OF KOREA; AND EX. O., 94TH CONG., 2D SESS., PROTOCOL TO THE 1975 INCOME TAX CONVENTION WITH THE REPUBLIC OF THE PHILIPPINES

JULY 19 AND 20, 1977





Printed for the use of the Committee on Foreign Relations

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TAX TREATIES WITH THE UNITED KINGDOM, THE REPUBLIC OF KOREA AND THE REPUBLIC OF THE PHILIPPINES

TUESDAY, JULY 19, 1977

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

The committee met, pursuant to notice, at 10:19 a.m., in room 4221, Dirksen Senate Office Building, the Honorable Frank Church presiding.

Present: Senators Church, Pell, Clark, Stone, and Javits.

Senator CHURCH. I want to apologize to the witnesses who have been kept waiting.

I was down at the White House this morning, and the proceedings there lasted longer than anyone had anticipated. So we are getting off to a late start this morning.

OPENING STATEMENT

Today we begin 2 days of hearings on three tax treaties between the United States and the United Kingdom, the Philippines, and Korea.

While there has some concern over certain provisions in the treaties with the Philippines and Korea, it is the treaty with the United Kingdom that has sparked the most controversy and potentially has the most significance for our foreign policy.

In May of 1975, the United Kingdom enacted a petroleum revenue tax, or PRT, on oil company earnings from North Sea oil. As today's testimony will show, that same year our Internal Revenue Service expressed the view that the PRT was not a creditable tax under U.S. law. The United Kingdom then asked that the United States and the United Kingdom enter into a tax treaty to assure the creditability of the PRT, which it does. The matter is here for review by the Senate, and properly so, for the decision to make creditable an otherwise non-creditable foreign tax on oil company earnings is replete with foreign policy considerations that affect our national security.

It is exactly this same set of procedures that should be followed with OPEC's taxes, in my judgment. The Internal Revenue Service is currently reviewing the creditability of OPEC's taxes on oil company earnings. As with the PRT, the Internal Revenue Service should make the decision strictly according to our tax laws. If the Internal Revenue Service declares the OPEC taxes not creditable, then the proper format for any further consideration of the creditability of these taxes is a tax treaty, which is subject to the advice and consent

of the Senate. Only then can the foreign policy decisions involved be given a full airing.

What should not happen is a repeat of the 1956 tax ruling, where the National Security Council's desire to provide foreign aid to Saudi Arabia led to the creditability of these taxes, regardless of their technical merits, and without review by Congress.

The matter is a serious one for our energy and foreign policy, for if the U.K. treaty fails for other reasons, and the IRS does not expeditiously review the creditability of OPEC taxes, the United States will be providing incentives for companies to produce OPEC's cartel oil and not produce oil from the United Kingdom or elsewhere in the world.

The U.K. treaty also limits the States' ability to use the unitary apportionment method of taxation. This has been the most controversial aspect of the treaty, with strong arguments being made on both sides of the issue. Over these 2 days I look forward to hearing the perspectives of our witnesses on this matter. The refund of the U.K.'s advance corporation tax is also a central provision on which we expect to hear testimony.

POSTPONEMENT OF CONSIDERATION OF OTHER TREATIES

Two other tax treaties, one with Egypt and one with Israel, were originally scheduled to be considered by the Foreign Relations Committee today and tomorrow. They have been postponed at the request of the Department of the Treasury because of technical problems. I will enter into the record Treasury's letter requesting this postponement.

[The information referred to follows:]

DEPARTMENT OF THE TREASURY,
Washington, D.C., July 18, 1977.

HON. FRANK CHURCH,
U.S. Senate, Washington, D.C.

DEAR SENATOR CHURCH: I am writing this letter to you since you are chairing the Senate Foreign Relations Committee hearings on various tax treaties on July 19 and 20, 1977. We would like to request that the Israeli and Egyptian treaties not be considered at this time.

In the case of the Israeli treaty, questions have been raised regarding the provision dealing with Israeli government grants to promote U.S. investment in Israel. The provision has given rise to technical questions and in any event we have recently been advised by Israel that the provision has no applicability under current Israeli law. We also understand that possible revisions of the tax laws of Israel are currently being considered.

Egypt is also in the process of amending its tax laws. In addition, there are technical problems which have been identified in the Egyptian treaty which the Treasury would like to have more time to consider.

In view of these technical problems which have recently come to my attention, we would be most appreciative if the hearing insofar as it relates to the Israeli and Egyptian treaties could be postponed. I apologize for the shortness of time involved, but it was not certain until late last week that additional time would be needed.

We will, of course, be discussing these technical matters with the representatives of the Israeli and Egyptian governments in the near future to determine whether changes in the treaties would be appropriate. We hope to get back to you soon on this matter.

Sincerely yours,

LAURENCE N. WOODWORTH.

Senator CHURCH. In addition, because of the extensive controversy over various provisions of the U.K. tax treaty, the Foreign Relations Committee will keep the record open for another 2 weeks beyond tomorrow so that all those who have not yet submitted written testimony may do so.

Our first witness this morning is the Commissioner of Internal Revenue, Mr. Jerome Kurtz.

LETTER FROM CHAIRMAN ULLMAN

Before we begin with the testimony, however, it has been called to my attention that we have just received a letter from Al Ullman, the chairman of the House Ways and Means Committee, requesting that a reservation be attached to the U.K. treaty with respect to the unitary tax provision. It is Mr. Ullman's provision that this is a question of tax policy that ought to be decided in the ordinary course of determining our tax laws and should not be decided by way of treaty with individual foreign countries. He therefore requests strongly that the committee, if it sees fit to recommend the treaty, do so with a reservation exempting the unitary tax provision.

Without objection, I will ask that Chairman Ullman's letter be included in the record at this point.

[The information referred to follows:]

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., July 18, 1977.

Hon. JOHN SPARKMAN,
Chairman, Senate Foreign Relations Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The proposed income tax treaty between the United States and the United Kingdom is scheduled for hearings before the Senate Foreign Relations Committee on July 19 and 20, and I would like to take this opportunity to offer the Committee my views on Article 9(4) of that treaty. This provision restricts the use of the combined reporting method by the various States of the United States in taxing British multinationals operating within their borders.

As you are aware, several States use a combined reporting apportionment methods in determining the taxable income derived by multinationals from sources within their borders. The proposed treaty provides generally that in determining the tax liability of either a British corporation doing business within a State, or of any subsidiary (U.S. or foreign) doing business within a State which is controlled by a British corporation, the State may not use the combined reporting method to take into account the related business activities of any foreign affiliates.

This unpredecented provision is outside of what has traditionally been considered to be the scope of U.S. tax treaties. It is the first attempt to restrict the taxing authority of State and local governments by a substantive provision of a U.S. tax treaty (other than the usual nondiscrimination provisions). This treaty provision would have a significant impact on those States, including California, Oregon and Alaska, where combined reporting on a unitary basis is frequently required.

Any limitation on the use by the States of combined reporting raises a number of very serious issues. First, there is considerable disagreement on the question of whether the combined reporting method is a more or less appropriate apportionment method to be used by a State compared with the arm's-length method generally used by the Federal Government. Second, important issues of Federalism are raised by any attempt of the Federal Government to

limit the taxing power of State and local governments. The particular limitation provided in this treaty also raises questions of discrimination because the limitation applies only with respect to British multinationals, but it does not require similar treatment for U.S. multinationals or third-country multinationals.

It is my belief that if the Federal Government is to place any limitations on the use of combined reporting by State or local taxing authorities, the limitations should be imposed through the regular manner by legislation and not through bilateral tax treaties. The legislative process would give both Houses of Congress the opportunity to hear and consider fully all sides of the issues involved. Moreover, the issues could be considered on their own merits, rather than determined as a *quid pro quo* for concessions made by a foreign government, which concessions do not benefit the States and localities whose taxing jurisdictions are being limited by this negotiated package. Fnally, the legislative process would permit uniform rules to be applied to all taxpayers, U.S. and foreign.

On March 8 of this year, a task force of the Ways and Means Committee issued a report recommending the adoption of legislation in this area. This legislation would, in most instances, preclude the States from taking into account through combined reporting the operations of foreign affiliates of multinationals, U.S. or foreign. This recommendation, together with any recommendation on the subject which may be made by the Administration, will be considered by the Ways and Means Committee later this year when it receives the Administration's tax reform proposals.

For these reasons, I urge the Senate Foreign Relations Committee to recommend to the Senate that its advice and consent to the ratification of the proposed treaty be reserved with respect to the limitations placed on the taxing powers of States and localities by Article 9(4).

Sincerely yours,

AL ULLMAN.

Senator JAVITS. Mr. Chairman, do I understand that this letter comes to us from Congressman Ullman, whom I know and admire, in his individual capacity as a Congressman, or does he speak for the Ways and Means Committee?

Senator CHURCH. He signed the letter, and it reads as though it represents him in his individual capacity.

Senator JAVITS. I see. Also, may I suggest, because this is an important question, that the witnesses be sure to address themselves to the unitary tax question for those 3 States that have it and how that system affects the other 47 States. Also, would the witnesses please give us any precedents with respect to treaties which comparably affect the right of States to tax which have been ratified after having been entered into by the President?

Thank you.

Senator CHURCH. Mr. Commissioner, we are happy to welcome you.

STATEMENT OF THE HON. JEROME KURTZ, COMMISSIONER, INTERNAL REVENUE SERVICE, ACCOMPANIED BY STUART SEIGEL, CHIEF COUNSEL, INTERNAL REVENUE SERVICE

Mr. KURTZ. Thank you.

Mr. Chairman and Senator Javits, I am accompanied this morning by Stuart Seigel, Chief Counsel for the Internal Revenue Service.

I am pleased to be here to address the three points raised in your invitation to testify. Your interest in the subject is welcome, and it has caused me to focus my personal attention on these important issues.

The points you raised are: One, the creditability of the United Kingdom's petroleum revenue tax under our tax laws; two, the status of Internal Revenue Service rulings on the creditability of OPEC taxes on oil company operations; and three, why creditability of OPEC payments is allowed pursuant to IRS tax rulings but a tax treaty is considered necessary in the case of the United Kingdom's PRT.

CREDITABILITY OF U.K.'S PRT UNDER U.S. TAX LAWS

Concerning the first point, the creditability of the United Kingdom's PRT under our tax laws, the IRS had expressed the view in 1975 that PRT would not be a creditable tax.

I am attaching and will submit a copy of a memorandum of July 28, 1975, from the Internal Revenue Service to Treasury setting forth our reasoning.

Generally speaking, a foreign tax, to be creditable, must be an income tax. Whether a particular foreign tax is an income tax is frequently not an easy question.

The standard against which it is tested is the U.S. concept of an income tax. But, the U.S. income tax is not a pure income tax in itself. Our budgetary process, for example, recognizes that our income tax law contains a substantial number of specific deviations from a generally accepted definition of income. These are the tax expenditures, some 80 in number and $95 billion in amount.

So, the difficulty has been to determine those factors which are essential to our concept of an income tax, and then to determine how much variation from these items there may be before a tax ceases to be an income tax for credit purposes.

The concept of taxing only realized net income and gains has been considered by most courts to be central to our notion of an income tax, although there are differences as to how this test may apply in particular cases.

PRT appeared to have violated these notions by forbidding offsets of losses from one oilfield against gains in another oilfield, the so-called "ring fence" concept, and by taxing unrealized gains in unrefined oil. The issues in this area are not 100 percent clear, for one reason, as I said, because the U.S. tax law against which we measure foreign taxes is not a clear model.

Accordingly, we suggested that the then-pending income tax treaty negotiations with the United Kingdom deal with this issue about the PRT tax matter to avoid uncertainties, or disallowance of the credit, assuming a policy decision to grant creditability.

IRS RULINGS ON CREDIBILITY OF OPEC TAXES

The second point you have asked me to discuss is the status of IRS rulings on the creditability of OPEC taxes on oil company operations.

The status of our rulings on the credibility of taxes on oil company operations in some of the OPEC members, is that they are under active study. I will describe the problems under study in general terms, but section 6103 of the Internal Revenue Code prohibits my disclosing the status of the affairs of particular taxpayers.

The relationships between some of the OPEC members and the oil companies operating there raise hard tax questions. One basic problem is how to differentiate meaningfully a creditable tax from a royalty where a soveign government is both the tax and royalty collector. Another problem is whether a foreign tax, which is otherwise based on net income, loses its creditability when based on an artificial sales price, such as a posted price, varying from the market price. Is such a deviation from our model a fatal flaw?

These are difficult, time-consuming questions to answer, which are made more difficult for the Service by factfinding problems.

What is the applicable foreign law? Do any private agreements exist between the foreign government and the oil company which have the effect of modifying the foreign law? How are the foreign laws applied to the operations of particular oil companies?

We must translate foreign tax laws, get what facts we can from the taxpayers and our field audit personnel, receive extensive briefs from taxpayers, research and analyze our own positions and replies, get more information as to the application of the foreign tax laws in specific instances, and coordinate tax policy matters with Treasury.

We come to those problems today facing a long history of ruling oil taxes creditable from 1950, in the case of the Venezuelan tax, 1955, as to the Saudi Arabia decrees, and 1968, as to the Libyan surtax on oil concessionaries, among others.

In 1976, we published a revenue ruling holding, in essence, that no foreign tax credit resulted from a production sharing arrangement between Indonesia and certain oil companies, in part on the theory that the foreign law there arbitrarily limited deductions.

Moreover, each OPEC member has a checkered tax history of its own.

Our current study of the tax laws, as applied in some of the OPEC members, is well advanced, but not final. In others, we have not yet developed the facts. The events move faster than our audits and rulings. We will, however, accelerate our action in this area.

OPEC PAYMENTS' CREDIBILITY AND NECESSITY OF U.K. TREATY

Your third question is why credibility of OPEC payments is allowed pursuant to IRS tax rulings, but a tax treaty is considered necessary in the case of the United Kingdom's PRT. The variant results in some of the OPEC members and PRT are functions of technical differences in the laws.

The OPEC tax laws ruled upon in 1955 and 1968, read literally, do impose an income tax on oil companies which in many respects is similar to the U.S. income tax. There is no "ring fence" problem, for example, in the Saudi Arabia decrees. The problems presented by some of the OPEC taxes are different from that presented by PRT.

We are now, and have been, reexamining the entire area with the care it deserves.

In reexamining this area, as we are currently doing in the OPEC tax context, one of the substantive issues we are working on, as I said, is how to distinguish a royalty from a tax, assuming both are levied by a sovereign government. On the one hand, we are not ready to accept that the name of the levy alone should necessarily control.

On the other hand, it is difficult to overrule the characterization of a sovereign entity that a portion of its levy is an income tax, and characterize it as a royalty, particularly where that sovereign entity, in fact, imposes a separate royalty. Should we examine the reasonableness of the separate charges? What is the reasonable value of oil concessions, and who has the authority to make this determination?

The legislative restrictions in 1975 and 1976 limit the amount of the foreign tax credit on oil income and tax benefits from using excessive foreign tax credits. Even after these legislative changes, the current statutory rules permit taxpayers to extinguish U.S. tax obligations on foreign source income in their entirety by use of the foreign tax credit.

The issue of whether the original IRS ruling should be revoked because posted prices exceed market prices for oil is also a difficult one. On the one hand, artificially raising gross receipts by a posted price in excess of market may create a noncreditable foreign income tax on the theory that using artificial gross receipts is tantamount to imposing a gross receipts tax which does not technically qualify for treatment as a creditable foreign tax, or alternatively, that a tax on artificial income so substantially deviates from our notion of an income tax as to be noncreditable. Such an approach would require reversing a number of issued rulings.

However, one might argue that the tax is, in part, a valid income tax to the extent of fair market value, and in part a noncreditable excise tax on the excess. In the case of our 1976 Indonesian ruling, the foreign law is being revised to attempt to structure a creditable tax.

I am not suggesting that we are throwing up our hands at these issues. Rather, I am pointing out that the issues are difficult ones which must be carefully considered. These, in fact, are the issues on which our work is now focusing.

We are taking a fresh look at these complex problems. But I would be less than candid if I promised easy solutions or immediate results. What I do promise is our best renewed efforts as tax administrators, recognizing the long history of difficulties, contradictions, and lack of clarity in the foreign tax credit field.

I will be glad to try to answer any further questions that you may have, Mr. Chairman.

[The memorandum of July 28, 1975 follows:]

DEPARTMENT OF THE TREASURY,
July 28, 1975.

UNITED KINGDOM PETROLEUM REVENUE TAX.

FREDERIC W. HICKMAN,
Assistant Secretary for Tax Policy.
LAWRENCE B. GIBBS,
Assistant Commissioner (Technical).

In your letter of May 28, 1975, to the Commissioner of Internal Revenue, you indicated that the United Kingdom Petroleum Revenue Tax ("PRT") appeared to be imposed on net income and could therefore appropriately be included among the income taxes covered by the treaty currently being negotiated with the United Kingdom.

Our study of the PRT indicates that the PRT is not a tax based on net income and would therefore not be creditable under U.S. concepts. We note that the PRT is imposed in some measure on unrealized gain in that the tax base

computation includes revenues from the valuation of oil which has not been transferred, but which is in the process of being refined by the extracting company. See Paragraph 2(5)(C) of the PRT. Furthermore, although there is an automatic protection against the PRT being assessed against low return fields (Paragraph 9(1)), a taxpayer may not offset losses in one field against gains from another field, nor may he, it appears, use losses from outside his oil activities to offset his PRT liability. Thus, a taxpayer may have an overall loss but nevertheless be required to pay tax under the PRT.

Because of the method of computing the tax base as described above, the PRT does not reach "net gain" and is not therefore an income tax within U.S. concepts. More likely the PRT is in the nature of a royalty or excise tax.

We note further than Part II of the Oil Taxation Bill (Part I of which enacts the PRT) amends the present U.K. Corporation Tax so that a taxpayer may not offset gains from within the oil field "ring fence" with any losses from outside the "ring fence." Thus, as in the PRT, it appears that a taxpayer may have an overall loss but be required to pay the U.K. corporate tax. We now, therefore, have doubts as to whether such tax, as amended, is creditable under U.S. standards.

Should it be decided to make the PRT creditable for treaty purposes, notwithstanding that it would not otherwise be creditable, an explicit statement in the legislative history to that effect will greatly reduce potential problems in other treaty and non-treaty country situations.

(Signed) S. A. WINBORNE,
FOR LAWRENCE B. GIBBS.

HISTORY OF CHANGE FROM ROYALTIES TO INCOME TAXES

Senator CHURCH. First of all, Mr. Commissioner, when the Subcommittee on Multinational Corporations looked extensively into the international oil arrangements, we developed, in the course of a very extensive investigation, the history of how it came to be that taxes that had been considered, and properly so, royalties, excise taxes, suddenly became income taxes by virtue of a change in the tax regulations of the Internal Revenue Service. Years later John J. McCloy, who was the attorney for the major oil companies, in a letter to Secretary of State Dean Rusk, gave that history and explained why that decision had been made. I will quote from his letter to the Secretary of State:

I believe that the Department of State has a particular responsibility to make known to the Treasury Department the implications of its proposed attack on crude oil prices because the present system of providing substantial revenues to the oil producing countries of the Middle East by means of a combination of royalties and local income taxes on the producing companies, which are creditable under U.S. tax law, was recommended to the oil companies and to the foreign governments involved by the Department of State and the Treasury Department. These Departments recognized that it was in the national interest of the United States to keep such nations stable and friendly to the United States, and thereby insure American access to the vast oil reserves there located. If the oil companies did not provide the necessary revenues by paying substantial taxes to the producing countries, large amounts of direct foreign aid might well be required.

Our testimony, which was all sworn testimony, then bore out the details of what happened and the picture is very clear. After the first Arab-Israeli war, there was a great political resistance in the Congress to appropriating foreign aid to these governments. The international oil companies, through an elaborate system of cartel arrangements, controlled both production and price—or, I should say, controlled price through the control of production.

At that time they were in the saddle. The governments needed extra money. A decision was made in the National Security Council—and what I am telling you now is all documented—which was not based upon the principles of taxation as they had been applied before, but for foreign policy reasons, because we wished to extend additional financial assistance to these governments. They were, at the time, very anti-Communist, and our purpose was to prevent the enhancement of Communist influence in the area. They were dominated by the oil companies in such a way that this has become a highly important source of oil supply to the Western World.

The effect of this tax ruling, which suddenly treated royalties as creditable income taxes was to transfer billions of dollars out of our Treasury, and into the treasury of these oil-producing governments of the Middle East.

I think there is little historic dispute about how it happened or about why it happened. It all happened without the matter coming to the Congress, without any debate, and indeed, without any public recognition of what was happening at the time.

All of those considerations, which may have made sense then, have evaporated. In fact, the complete reverse is now true. These governments are not in need of money; they are the richest in the world. The considerations which led to that decision no longer exist.

CONSTRUANCE OF OPEC PAYMENTS AS INCOME TAXES QUESTIONED

You have said that it is very, very difficult to determine whether or not these taxes are income taxes. I should not think it would be very difficult when OPEC itself has told us that they are, in effect, excise or royalty taxes. For example, on December 13, 1974, the OPEC pricing system announced that a rule had been established that the average government take from the operating oil companies would be $10.12 per barrel, for the so-called marker or standard crude. This $10.12 could be made up of any combination of taxes or royalties, backpayments or other payments, so long as these various elements always totaled $10.12 per barrel.

I don't know by what convoluted method of reasoning a formulation of that kind, announced by OPEC itself, can be construed to be an income tax under any definition.

Mr. KURTZ. Let me say first, Mr. Chairman, that the decision that will be reached as a result of the study now in progress will be a principled legal decision without regard to whatever foreign policy implications there may be. The IRS is the administrator of the revenue laws, and will look at the Internal Revenue Code, we will look at cases in court, and we will reach a decision.

As to the substance of the point that you raise, as to how any part of the payments could be construed as a tax, I hesitate to get into the substance because our studies in the area are not complete. The structure of the combination of taxes and royalties does vary from country to country and in some respects there is difficulty in generalizing. But let me just present a hypothetical case, if I may, to try to point out some of the difficulties, and why we feel, at least, that the answer to the question is not an obvious one in all cases.

If a country were to have an income tax, let us say, of 50 percent of net income, and it also happened to own oil lands, and it decided it wanted a total take from the oil lands of some amount larger than 50 percent of income, it could impose a royalty on the difference. I think in that case there would be no doubt that the taxed portion was a tax, even though the total payment was a payment paid by someone who was using nationally owned lands and extracting minerals from them.

There are court cases which have held that a tax imposed by a government on a single industry, if it is an income tax in the sense of one computed on net income, is creditable, notwithstanding the fact that it is not generally applicable, but limited to the particular industry.

This presents us with very substantial problems. If a country is permitted to have, under court decisions, an income tax applicable only to companies engaged in mineral extraction, and it also obviously has a right to charge a royalty because of the land that it owns, the sorting out, I believe, is not obvious.

OIL COMPANIES' TAX ATTORNEYS' ASSESSMENT OF SITUATION

Senator CHURCH. Let me just read to you another telegram that was sent by the major oil companies' tax attorneys to the major oil companies—that is, their own tax attorneys to them—making their own assessment of the situation. This was in 1970 and 1971. This took place during a period when the oil companies were trying to combine together to negotiate with OPEC, and OPEC was just beginning to gain muscle, and, of course, the tax creditability was an important issue to these companies.

This is what the tax attorneys had to say to their principals, the international oil companies, and I quote:

> The essence of creditability of the income tax under existing arrangements is that companies agree that export sales will be made at the prices on which the tax is to be based and sales are so made, even though market values might be lower. This has been in terms of published prices, less discounts permitted for certain period.
>
> The artificiality of this system is obvious and well known, but it has not been challenged by the Internal Revenue Service. If agreement for the future is that companies will make export sales at January 1971 published prices, plus or minus adjustments from time to time pursuant to an agreed formula, I cannot see why creditability is less secure than if companies agreed prospectively to change the published prices as such from time to time. In either case, the artificiality of the system becomes somewhat greater, but I cannot give any logical reason why the tax would therefore become noncreditable.

Here the attorneys for the oil companies themselves are telling their principals that it is well known that the whole system is artificial, but that nevertheless the Internal Revenue Service has not seen fit to challenge it, and the new system, which would be even more artificial, they thought would get by.

I don't mean to argue the details. You are saying that you are studying this matter again. I am glad that you are because I think that there is a very large revenue loss to the Government, perhaps as much as a third of a billion dollars a year, depending upon what decisions you reach. But I do hope that in view of the fact that this

confessed artificiality, confessed by the oil companies themselves, is so plainly now a part of the record, in view of the history which based this artificiality on foreign policy reasons that no longer exist, and economic reasons that no longer exist, then I think it is all the more imperative in the interests of our own country and the integrity of our own tax system that this be corrected. I am sure that you will look at it in a professional way.

Mr. KURTZ. I can assure you of that.

Senator JAVITS. Would the Chair yield for a question?

Senator CHURCH. Yes.

RELEVANCE OF IRS RULINGS TO U.K. TREATY

Senator JAVITS. I notice that the witness says that the second question he is asked to answer is the status of IRS rulings on the creditability of OPEC taxes on oil company operations.

Could we know, Mr. Chairman, what is the relevance of that question to whether or not we ratify the United Kingdom treaty?

Mr. KURTZ. Are you asking me that question, Senator?

Senator JAVITS. Yes.

Mr. KURTZ. I am not sure that it is relevant.

Senator CHURCH. Then, if you cannot supply an answer, I can.

I think it is relevant in the sense of how we treat the question of creditability on oil revenues.

The advice I receive on the British tax is that whatever difficulties there may be with it, it is much closer to an income tax than the combination of taxes in the Middle East. If we are going to say that that tax under our laws is not creditable in the absence of a treaty, then it makes all the more awkward and inconsistent the treatment that we are giving to the Arab governments.

Mr. KURTZ. Senator, what I meant by my answer is that from our point of view, that is, from the point of view of the Internal Revenue Service in developing these rulings, these will be developed on the basis of existing law. Certainly, as Senator Church says, it may well be that the result of the entire process would be to produce some undesirable consequences in some respects, depending on how the rulings come out. But the way the treaty may go will not affect the way we proceed with our rulings, which will be based on existing law.

QUESTION OF TIMING OF IRS RULINGS AND RATIFICATION

Senator JAVITS. May I explain this to the chairman. I am the ranking member of the chairman's own Subcommittee on Foreign Economic Policy. I thoroughly agree that the OPEC question is very relevant to the work of our committee. We should definitely get some answers from you.

What troubled me was whether or not we should wait until you decide on the OPEC question before we pass on the United Kingdom treaty. That is why I asked what may have sounded like a provocative question, although I had no design to be provocative. It is, however, an important question for me, whether we are to wait for the IRS to make this decision before ratifying the tax treaty because we want to

evaluate the total policy and decide whether or not to ratify, what could be an exception or may not be an exception, which is dependent on how you decide what I consider to be a big question. That may mean considerable delay. That is where you come in. You have to tell us. On the other hand, the public policy requires that we do act on this treaty. So all I was trying to pinpoint, Mr. Chairman, was the timing question. There is no question about the general relevance of your concern to the policy of the United States. The Chair is 100 percent right on that.

Mr. KURTZ. The question of timing is one that I hoped you would not ask.

[General laughter.]

Senator JAVITS. I get paid this huge salary for doing that.

[General laughter.]

Mr. KURTZ. It is very difficult to know. It has been worked on. A great deal of work has been done over the past 2 years, and we are, I think, moving toward a resolution of at least some of the issues.

We have a number of rulings pending in a number of the various OPEC members. A consideration of some of the particular taxes is considerably more advanced than consideration of others. I hesitate to put a deadline on this, but I would think it would probably be several months and perhaps longer until anything comprehensive is produced.

Senator JAVITS. Thank you very much, Commissioner.

Mr. Chairman, may I be excused for a few moments? I will be right back.

Senator CHURCH. Certainly, Senator.

If you can keep to that schedule, Commissioner, you certainly would satisfy this committee. Our experience in the past suggests that when it comes to decisions that have the effect of increasing the tax bite on large oil companies, we may wait until the next ice age.

[General laughter.]

PROHIBITION AGAINST TAXING INCOME FROM BRITISH-OWNED SUBSIDIARIES

Senator CHURCH. The other part of this treaty that has occasioned considerable controversy and has raised doubts in my own mind is that part that would, in effect, forbid State governments in our country from enacting and enforcing the unitary tax on income from British-owned subsidiaries doing business in this country. Could you comment on that?

Mr. KURTZ. Mr. Chairman, I think that is an area more appropriately addressed by Dr. Woodworth. It is a policy issue, and at this point it does not involve the Internal Revenue Service.

MODIFICATION OF TAX LAWS ON BASIS OF BILATERAL TREATIES

Senator CHURCH. Then let me ask you this. From the standpoint of the Internal Revenue Service, which is charged with administering the tax laws of this country, is it your position that those tax laws should be modified on the basis of bilateral treaties with individual governments?

Mr. KURTZ. Well, sir, again, I think that my role as an administrator is to administer the law as handed to us, whether enacted by Congress or by bilateral treaty. The choice of method of doing it is one which is outside the area on which I should appropriately comment. It is a matter of policy, which again, I think, falls within Dr. Woodworth's purview.

Senator CHURCH. If we approve a treaty that gives certain tax treatment to British-owned companies doing business in this country, but have no comparable treaty with Germany, Italy, France, or Japan, let's say, with respect to their businesses in this country, would that not be complicating for the Internal Revenue Service, or is it a matter of indifference?

Mr. KURTZ. It is a matter of relative indifference. We have, certainly, now in existence a substantial number of treaties, some of which vary in particular provisions, and we have been able to handle the variations adequately without any substantial administrative burden.

MOVING IRS REVIEW AHEAD WITH ALL APPROPRIATE SPEED URGED

Senator CHURCH. I think that that being your position, or nonposition, on that question, I can only urge you to move forward with all appropriate speed in your review of the way that we permit creditability of that combination of taxes that are now being imposed by the OPEC governments. If you have had difficulty in allowing creditability for the English tax, thus occasioning this treaty, I should think you would have immensely more difficulty justifying the creditability that historically was given for foreign policy reasons and is acknowledged by the companies themselves to be artificial in connection with the lost revenues in the Middle East. I would hope you could complete those studies in a reasonable time and reach some decisions.

This committee, and particularly the Subcommittee on Foreign Economic Policy, would like to be kept apprised of any decisions that are reached and the reasons for them.

Mr. KURTZ. I can assure you, Mr. Chairman, that we are treating this as a matter of great importance and high priority. We will keep our attention on it until it is resolved.

Senator CHURCH. Thank you very much.

Our next witness is Laurence N. Woodworth, the Assistant Secretary for Tax Policy of the Department of the Treasury. Mr. Woodworth is accompanied by David Foster, tax consultant for the Department of the Treasury.

STATEMENT OF HON. LAURENCE N. WOODWORTH, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY; ACCOMPANIED BY MR. DAVID FOSTER, TAX CONSULTANT, DEPARTMENT OF THE TREASURY, AND MR. CHARLES KINGSON, INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY

Mr. WOODWORTH. Thank you.

Mr. Chairman, I am very pleased to appear before your committee today in support of three income tax conventions currently pending

before the Senate—treaties with the United Kingdom, Korea, and the Philippines. Two other treaties, with Israel and Egypt, are pending before the committee but at our request are not being considered at this time.

WHY WE HAVE TAX TREATIES

As tax treaties have not been before the committee for several years, I would like to take this opportunity to review briefly the purpose and direction of our tax treaty program. I think, Mr. Chairman, that this goes to the question that you were just asking; if I understood you correctly, this was why do we have tax treaties. It is that tax treaties by their nature deal with issues that affect the two nations involved.

Senator CHURCH. May I ask if it would be possible for you to summarize your statement, or was it your intention to read it all?

Mr. WOODWORTH. I had in mind going through parts of my testimony which I would suppose would be about two-thirds of the written statement. First, I was going to indicate why we think tax treaties are desirable, as such. Regarding the U.K. treaty, I would discuss the three issues that have caused controversy, and I would cover one issue in each of the other two treaties. But I will try to handle it any way you see fit.

Senator CHURCH. If I may suggest, I do not believe there is any argument between us as to the variety of tax treaties, as such. They have frequently served the interests of both countries. The U.K. treaty brings up some very controversial issues. So I think we could save time if that portion of your prepared statement dealing with the general usefulness of tax treaties could be incorporated into the record and then we could go directly to the tax treaty before us, the U.K. treaty.

Mr. WOODWORTH. I would be glad to do that, Senator.

I will read parts of my material, beginning on page 7.

Senator CHURCH. Fine.

SIGNIFICANCE OF U.K. TAX TREATY

Mr. WOODWORTH. The proposed treaty with the United Kingdom was signed on December 31, 1975. This treaty is, I believe, quite significant. Our economic relations with the United Kingdom are close and extensive. U.S. direct investment in the United Kingdom at the end of 1975 totaled $14 billion, and U.K. direct investment in the United States was $7 billion.

During 1975, U.S. investors received over $1 billion in dividends, interest, branch profits, and royalties from the investment. U.S. payments to U.K. investors totaled over $350 million.

Moreover, this treaty is important in principle because it breaks new ground in several fundamental respects. I am particularly interested in emphasizing the policy described in the portion of the testimony I am about to read, because I think that this represents a precedent for our relations with other nations which have integrated their corporate and individual taxes.

In integrating their corporate and individual taxes countries sometimes have tended to forget the foreign shareholders. The provisions of the U.K. treaty definitely take the foreign shareholders into account and are, therefore, very important as a precedent which, we hope, can be used elsewhere—in treaties with Germany, France, Canada, and a number of other nations in Europe which have already or are in the process of integrating or combining their corporate and individual taxes.

U.K. SYSTEM FOR TAXING CORPORATIONS AND SHAREHOLDERS

The dividend provision of the U.K. treaty reflects a major concession by the British. To understand this provision, it is necessary to outline the U.K. system for taxing corporations and their shareholders.

In 1973, the United Kingdom introduced a partially integrated system under which a portion of the tax collected at the corporate level is treated, with respect to distributed profits, as having been paid on behalf of resident individual shareholders.

Under the U.K. system, U.K. corporations are subject to an initial corporate tax liability of 52 percent. When a dividend is paid, a tax called the advance corporation tax, or ACT, is levied. This ACT is equal to thirty-five sixty-fifths of the net dividend, and it is credited against the corporation's regular yearend tax liability.

An individual U.K. resident shareholder pays tax not only on the dividend, but also on the ACT paid with respect to the dividend. However, he may claim a credit against his own income tax liability for the ACT. If he is a standard rate taxpayer subject to a 35-percent rate, the credit will exactly offset his tax on the dividend income. If he is subject to tax below the standard rate, he will receive a refund of the excess of the ACT credit over his tax due.

Thus, for a U.K. resident, the ACT is clearly a prepayment—and this is the important part—a prepayment at the corporate level of the shareholder's tax.

When the shareholder is a U.K. corporation, the general rule is that the ACT is paid, and the recipient corporation is not subject to tax on the dividend income. When that corporation, in turn, pays a dividend to domestic individual shareholders out of this dividend income, there is no further ACT to be paid, and the ACT paid on the original dividend passes through and attaches to the second dividend. In other words, they pay the ACT once, but not twice.

Alternatively, the first corporation may elect not to pay the ACT in the case of dividends to a related domestic company, but in this case the second corporation becomes liable for payment of the ACT when it pays that income out as a dividend to individual shareholders.

However, when the shareholder is a nonresident alien, such as a U.S. resident, the situation is quite different. British law provides that the ACT must be paid upon any distribution, but there is no credit or refund allowed to the nonresident shareholder, corporate or individual.

This treatment discriminates against U.S. investors in the United Kingdom, since for U.K. shareholders, the effective underlying cor-

porate tax rate with respect to distributed profits is just over 26 percent, after allowance of the ACT credit while, in the absence of this treaty, for nonresident shareholders the rate remains at 52 percent.

I think that this shows as much as anything one very important reason for this treaty.

EFFECT OF HEAVIER TAX BORNE BY U.S. SHAREHOLDERS

Senator CHURCH. May I ask you a question here, please? When did this ACT which integrates or partially integrates the tax become law in England?

Mr. WOODWORTH. It was in 1973.

Senator CHURCH. Has the heavier tax liability that American nonresident shareholders bear in the absence of this treaty shown up in a lower level of American investment in the United Kingdom?

Mr. WOODWORTH. The relative tax level has been increased by the adoption of the new U.K. law, but this treaty is retroactive to the date of enactment. Therefore very substantial retroactive payments will be made by the United Kingdom.

Senator CHURCH. But my question was, due to the fact of the absence of a treaty, American shareholders have been subjected to a heavier tax than have British shareholders.

Mr. WOODWORTH. Yes.

Senator CHURCH. Has that had the effect of diminishing the amount of American investment in England, American shareholder investments? Did you look into that?

Mr. WOODWORTH. That is very hard to establish. The very fact that this treaty was in process and that many of those shareholders have known that this treaty was in process might have tended to offset any such deminution. They have been able to anticipate that there would be a change made, and this has been public for quite sometime, now.

Senator CHURCH. But they could not anticipate that a treaty would really be worked out or that the Senate would ratify it.

Mr. WOODWORTH. The treaty has been published, and, as you know, it has been ratified by the British.

Senator CHURCH. Then is your answer to my question that you do not know whether investment has, in fact, been influenced?

Mr. WOODWORTH. I do not have any evidence of that, and I further suggest that since they did have this knowledge of the treaty in process, it would not be likely to be much of a factor in this period.

The discrimination produced by the ACT is potentially of significant dollar magnitude, and it must be viewed as a serious problem. We concluded that an income tax treaty is probably the only appropriate vehicle for mitigating the discrimination.

NEW U.K. TAX SYSTEM NOT UNIQUE

The new U.K. system is not a unique or isolated phenomenon, but rather is likely to be the prototype for European tax systems generally.

A June 1975 draft directive of the Commission of the European Economic Community calls for adoption of similar integrated cor-

porate/shareholder tax systems by all Common Market countries. Such a system has been in place in France for sometime, and the new tax law in West Germany follows a similar approach.

It is, therefore, apparent to us that a precedent must be established early if we are to deal effectively in subsequent negotiations with other countries employing integrated systems. This fact may have led to Britain's initial reluctance to deal with the integration-caused discrimination at the present time, while EEC policies with respect to this issue are still in a formative stage.

REDUCTION IN DISCRIMINATION UNDER ARTICLES 10 AND 23

Under the rules of article 10, dealing with dividends, and article 23, dealing with elimination of double taxation, of the proposed treaty, the discrimination is substantially reduced.

For U.S. portfolio shareholders, defined as any shareholder except a corporation which owns at least 10 percent of the voting stock of the paying corporation, the treaty provides the same credit as that available to a U.K. shareholder.

Senator PELL. Mr. Woodworth, if the chairman would permit me, there is another committee meeting I have to attend at this time, so I would like to question you now, if I may.

Senator CHURCH. Yes, Senator, please do.

RHODE ISLAND'S PROBLEMS WITH USE OF SEPARATE ACCOUNTING

Senator PELL. I look forward to reading your testimony, Mr. Woodworth, and benefiting from it, but there is one specific question that as a Senator from Rhode Island I feel obligated to bring up.

RHODE ISLAND'S PROBLEMS WITH SEPARATE ACCOUNTING

The State of Rhode Island has problems with article 7, paragraphs 2 and 3 of the U.K. tax treaty. As you know, that article would require the use of an expanded separate accounting principle as the sole method of determining corporate tax obligations. Separate accounting conflicts with the present Rhode Island system, which is similar to, but not as far reaching in its application, as the unitary system used by California. Our Rhode Island tax administrator says in a letter to us that the use of separate accounting would cause a substantial fall in the revenues of our State.

I would be interested in your reaction to this and also would like to know what kinds of consultations took place with the States in connection with the negotiation of this treaty. To the best of my State's knowledge, there was no consultation on the part of the Federal Government with Rhode Island, as one of the 50 States, and I was wondering if this was just a single omission or a general omission.

Mr. WOODWORTH. I believe you are talking about article 7.

Senator PELL. Exactly, paragraphs 2 and 3.

Mr. WOODWORTH. We cannot see where in the case of Rhode Island there will be any change as a result of this provision, except pos-

sibly—and I am not sure of this and wish to verify it—in the case of the tax treatment of banks. I am simply reserving on that until I have the opportunity to check it.

My impression is that apart from some possibility there, there is no effect insofar as Rhode Island is concerned with respect to these provisions.

Senator PELL. That is not the view of the tax administrator of my State.

I wonder if there has been an opportunity for any exchange of views?

Mr. WOODWORTH. I would be glad to discuss this with him. I have to say, however, that I think he is mistaken, and I believe that we could establish that if we have an opportunity to discuss this.

This is identical language, it has just been pointed out to me, as appears in the present U.K. treaty. So, to whatever extent the provisions affect Rhode Island, they have done so for many, many years. In other words, there is no change at all in that regard.

I can even remove my comment about the banks, now, because the two treaties are identical.

Senator PELL. I would appreciate it if there could be some direct communication between you and the State.

Mr. WOODWORTH. I think this is unfortunate. There seems to be quite a lot of confusion on this matter. But, insofar as those provisions are concerned, they are in the existing treaty and have been in effect for many years. They are entirely unchanged. Furthermore, article 7 does not affect the State. It affects only the Federal Government.

CONSULTATION WITH STATES IN NEGOTIATING TREATY

Senator PELL. Regarding my other question, was there any consultation with the States in negotiating the treaty? Was Rhode Island perhaps the only State that was omitted?

Mr. WOODWORTH. There was not general consultation with the States.

Of course, as you may know, I have not been on this job for very long. But since I have been here, I have appeared before a meeting of State tax administrators, and there was an opportunity at that time for them to discuss this with me, and there was some discussion then.

Senator PELL. Our tax administrator says:

> To my knowledge, the Treasury Department has not requested input from any State, including Rhode Island, in drafting a document which has serious fiscal impact on the States' finances.

Mr. WOODWORTH. There was a public request for comment, a general public request, and as I indicated, I did appear before a State tax administrators' meeting. In other words, they had the opportunity to submit information. On the particular points that the Rhode Island tax administration has raised, it is impossible that there would be any problem, because existing treaty provisions are unchanged.

Senator PELL. I wonder if Mr. Foster, who was here in the previous

administration, has any knowledge of any direct consultation with the States.

Mr. FOSTER. Not other than the consultations of the type that Dr. Woodworth just mentioned. We have been appearing in panels before State groups and with State groups, and our door is always open to anyone who wants to come in and talk.

We have not sought out the States, however, or anyone else to consult in connection with the treaty.

Senator PELL. I would think that would be good since there is some impact here. You say that there is a notice in this regard. What does that mean? Is it a notice put in the Federal Register or a notice mailed to the appropriate committee?

Mr. FOSTER. It is a press release that goes out to everyone on the tax list. It is published in BNA [Bureau of National Affairs] and CCH [Commerce Clearing House] Prentice Hall, the Federal Register—so it receives a fairly wide circulation.

Senator PELL. I thank you for your answers, and I will consult with my own State tax people in connection with the consultation on this.

Mr. WOODWORTH. Senator, we would be glad to discuss it with them if they would like. In the area, at least, where they have expressed concern, I don't see how there could be any effect.

Senator PELL. This particular Senator's view on the treaty will be measured in part by that, so it might be a good idea if you made a call to my tax administrator.

Mr. WOODWORTH. All right. I would be glad to do that.

Senator PELL. Thank you, and thank you, Mr. Chairman.

Senator CHURCH. I might follow up on Senator Pell's question by asking one of my own.

STATES' ADOPTION OF UNITARY TAX SYSTEM

What States have adopted a unitary tax system for treating with global corporations?

Mr. WOODWORTH. There are basically three: Alaska, Oregon, and California. Other States have some features of their laws which maintain some characteristics of a unitary system, but there is relatively little impact, except in those three States.

Senator CHURCH. One of the reasons that other States that have not adopted the unitary tax system have expressed alarm over this treaty is that they are considering adopting the unitary tax. I know that in my own State this is the case. I have heard from both the present Governor and the previous Governor, now Secretary of the Interior, both of whom strongly oppose the provision in this treaty. They feel that it will have the effect of preventing them in the future, or other States so minded, to adopt a unitary tax system. You know the difficulties of trying to determine how much a global company earns in a given State with their bookkeeping methods. State governments have been extremely frustrated in their efforts to deal with this problem.

We discovered, in our investigation of the multinationals, that the bookkeeping and the transfer of profit, and the method of account-

ing as between the principal and the subsidiary, and the method of pricing, all effectively frustrate State governments in trying to determine what their fair share of the corporate profits may be. So, although only three States have now adopted the unitary tax, there are many other States that are becoming interested in doing so.

Therefore, the central question is, is it proper to deny these States that opportunity through the treaty process when the question is one so basic to general tax law?

Mr. WOODWORTH. A substantial part of my prepared statement deals with that, but I would be glad to talk about it with you right now, if you would like.

[Senator Church nods affirmatively.]

Mr. WOODWORTH. First of all, it is not clear that it always is advantageous for a State to use unitary apportionment. I understand that California has just held some hearings in which they raised some very real questions about whether they want to continue following the present unitary system.

I have a newspaper clipping dated the 13th of this month, from the Los Angeles Times, the headline of which is, "Brown Asks Changes in Business Tax." [See p. 317.]

I cannot verify the facts in this, except to say that I know that there was the hearing, and I know also that a representative of the Governor's administration spoke in this hearing and spoke against the unitary concept. The article says:

> The Brown Administration asked the State Franchise Tax Board Tuesday to consider exempting some multinational business operations from a tax method that allegedly discourages business expansion to California.
>
> Business and Transportation Agency Secretary Richard T. Silberman said such a move would encourage Japanese automobile and electronics industries to set up manufacturing plants here, with a resulting increase in jobs.
>
> Governor Brown has been advocating such moves in recent months to help counter critics who charge that his Administration has created a poor business climate.

The article goes on from there.

Senator CHURCH. We are going to have some California witnesses before us tomorrow. I understand that Governor Brown has made no decision yet and has asked for further hearings.

Mr. WOODWORTH. Yes.

MERITS AND DEMERITS OF UNITARY TAX SYSTEM

Senator CHURCH. It is interesting that the case for reconsidering the unitary tax in California is not based on the merits or demerits of the tax itself, but rather on the fact that other States have not adopted it, and this has tended to channel investment away from California to other States that have a more favorable tax system, or that would have a lesser tax impact on corporate investments.

Mr. WOODWORTH. Let me go to the merits, then, if I may.

Senator CHURCH. Yes.

Mr. WOODWORTH. This is the issue. The Federal Government and virtually all other governments in the world determine taxable income on the basis of what are arm's length transactions in dealings between related companies. This is the general rule.

The unitary system, which was initially, as I understand it, developed for dealing with transactions among States within the United States, is based upon three factors: sales, payroll, and property. If you have a situation where wages paid outside of this country are not in the same ratio to property or sales, as the ratio of these factors for operations within the country then you can get a distortion under the unitary system.

I am not about to say that you cannot get a distortion under the arm's length system. I think that the most serious problem in using the unitary system abroad is the fact that the arm's length rule is generally applicable in the world today, and it becomes very disconcerting for other countries and for companies of other countries doing business in the United States to have the general rule with which they are acquainted used by the Federal Government and to find that certain State governments do not follow that rule.

Regarding the operation of the unitary system, to the extent that it results in larger profits than would be obtained under the arm's length system, one can argue that the system is reaching profits that are not properly attributable to the United States and that in using the system the States are, in effect, going further than they should in subjecting that income to tax.

Senator CHURCH. Yes; one could argue that. But one could also argue that the arm's length system is not reaching profits and taxing them at all, that a great deal of profit is slipping through the system.

STATES' RIGHT TO DECIDE ON TAXATION SYSTEM

I am not a tax expert, and I would not want to joust with you on such matters. But I think what the States are saying is that they ought to be allowed to make the decision of what system of taxation they should apply, and that if they are not allowed to make the decision, then that ought to be a judgment reached by the Congress as a whole, based upon national tax policy, legislation dealing with national tax policy, and it ought not to be approached by the treaty route by singling out a certain country and starting there. The only handle the Congress has upon that is the ratification of the treaty by the Senate. The House of Representatives has traditionally had the prerogative under the Constitution of considering revenue measures first and determining tax policy initially, before it comes to the Senate.

So, here we have a method that circumvents the traditional and constitutional arrangement, or the normal arrangement, for determining our tax policy. Whether the unitary system or the arm's length system is the best, I would not know. But, the fact that the States think they ought to have the right to decide which kind of tax to impose is the issue here.

Mr. WOODWORTH. I might say in that regard that in a sense the very essence of tax treaties is that they do select out transactions between two countries and say that they shall be treated in one way rather than in some way under the general rule. It is a specific way provided for by the Constitution.

Senator CHURCH. Oh, yes. I am not doubting the constitutionality of doing this. What I am saying is that you have a constitutional system which generally gives to the House of Representatives the first right to consider revenue raising and to determine tax policy. The Senate participates, of course. But both Houses, by statute, determine those policies.

This method of going by treaty excludes the House entirely and brings to this committee the burden of making tax decisions through the ratification process of treaties brought here.

NEW GROUND BROKEN BY TREATY

You say that while that has been the purpose of tax treaties in the past, to set up special arrangements between governments, this treaty is yet unprecedented in the sense that it breaks new ground.

What new ground does it break? Is it that this treaty for the first time denies to State governments their right to decide what kind of a tax to impose on corporate earnings of foreign-owned subsidiaries in their States?

Mr. WOODWORTH. The new ground which this treaty breaks, which I consider important and significant, is the treatment of integrated corporate and individual tax systems abroad. This treaty has the effect of removing discrimination, or largely removing discrimination against U.S. shareholders of British corporations, either portfolio shareholders or direct shareholders. That was the original purpose for which the United States asked to renegotiate the treaty.

The provision that you are referring to on the unitary taxes was requested by the British Government on the grounds that——

Senator CHURCH. Was that the quid pro quo?

Mr. WOODWORTH. No. It isn't. We wouldn't have agreed to the treaty provision if we didn't think that that would make a good general rule. The Rostenkowski task force of the Ways and Means Committee has recommended a system of this type across the board. In the Treasury we believe that that is a good approach.

RESERVATION CONCERNING TREATMENT OF UNITARY TAX

Senator CHURCH. It might be, but if this committee were to attach a reservation to the ratification of the treaty stating that the treatment of the unitary tax in the treaty is reserved because it is our feeling that Congress should deal with that issue through general tax legislation in which both Houses would participate, what effect do you believe that would have? Would the treaty then fall, or do you think there is a possibility that the other provisions in the treaty would stand and the British would be willing to accept the reservation?

Mr. WOODWORTH. There is no way for me to be sure what would happen. Although the British have approved the treaty in the House of Commons, if we were to make a reservation of the type you refer to, they would have the opportunity to reconsider the treaty ab initio. The effect of that is very difficult to forecast. I know that they would consider this a serious matter. Without being sure, I would think

that it might be quite sometime, if that occurred, before we would be able to correct the unfortunate situation which exists today in the case of the divided payments to U.S. shareholders.

As I have indicated, however, I cannot be sure of that.

Senator CHURCH. That is a fair answer. I understand that for a certain set of people in this country, those who have stocks in British firms, this treaty would have a beneficial effect. But there is a very large question raised about whether we should start denying State governments their right to decide what kind of taxes to impose unless the Congress, both Houses giving full consideration to the matter, decides that that serves the general interest of the country and, therefore, should be incorporated into our national tax law.

Mr. WOODWORTH. I, of course, understand your point of view. I do want to indicate that treaties having an impact on States are not new. Outside of the tax treaty area I am sure you could point out more examples than I could. But in the case of tax treaties, after Senator Javits raised this issue, we started checking on that point here this morning, I found that the rules of our tax treaties with the following countries require that the State tax systems not be discriminatory in their impact: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Japan, Poland, Romania, Norway, Russia, and Trinidad and Tobago. Interestingly enough, our tax treaty with Sweden also applies to State taxes, in this case by reason of a Supreme Court case in California. This is the principal State that has expressed concern in this regard.

It certainly is not a new phenomenon to have tax treaties apply to States. Most of our tax treaties, in one respect or another, do apply.

PRECEDENTS' IMPOSING RESTRICTIONS ON STATES' OPTIONS

Senator CHURCH. As far as the prerogative of the State to determine the method of taxation, do you have any other precedent to cite besides the one you have cited, that is, nondiscrimination? Are there other precedents that impose different restrictions upon the States' options?

Mr. WOODWORTH. Yes.

The case I referred to when I mentioned the California courts was not a discrimination provision. The California Supreme Court recognized that U.S. tax treaties may, and in fact do, limit the scope of the State's taxing power. In *Scandinavia Airlines System* v. *Los Angeles*, the California Supreme Court held that the United States-Swedish tax treaty precluded property taxation of a Swedish airline operating in Los Angeles but registered in Sweden. So, there is at least that one example. There may well be others, but this is one that I know of now.

I should also point out, of course, that the basic issue of what States can tax in interstate taxation is a matter which has long been considered by Congress and in which there is legislation that has been passed. I am referring here only to the step beyond that, to international taxation. But it is well established that the Congress can act in this regard.

Would you like to have me summarize further?

Senator CHURCH. First I would ask Senator Stone if he has any questions which he would like to ask at this time?

Senator STONE. Yes, Mr. Chairman, I do.

Senator CHURCH. Please go ahead, Senator.

Senator STONE. Thank you, Mr. Chairman.

WHY UNITARY APPROACH IS DEEMED DISCRIMINATORY

On the substance of the issue, Dr. Woodworth, why is the arm's length transaction a fairer, more equitable, more accurate rule than the combined or unitary approach?

To put it another way, why is the unitary or combined approach deemed discriminatory?

Mr. WOODWORTH. Underlying the global application of the unitary system is the concept that the use of property, sales, and payments for labor are relatively uniform throughout the world. It is a handy rule to use within the States where there tends to be less difference.

Senator STONE. If you are talking about among the States of the United States, that might be a relatively valid assumption. But you are raising the point of whether it is a valid assumption to say that wage rates are the same throughout the entire world; for example, in the developing world compared to the industrialized nations.

Mr. WOODWORTH. That is correct. Also, exchange fluctuations makes the problem that much more difficult.

It seems to me that those factors lead to some very substantial questions about the application of unitary apportionment on a worldwide basis. I think it is also significant and important to consider the fact that the Federal Government, and practically all of the rest of the world, uses the arm's length procedure. Even if it were not the best, it is important that we all use the same test.

Senator STONE. Or the tax impact is apples as compared to oranges, and there is no way to find out what the impact is?

Mr. WOODWORTH. That is correct. One of the problems is that if the Federal and State governments are not on the same kind of system, even though one may be theoretically as good as the other, you can, in specific instances, have double taxation of the same income—in other words, have it taxed by two or more jurisdictions.

So, as I see it, it is desirable per se to have the same method of taxing income, whether or not you can declare one method to be perfect and the other one not.

STATES' ADOPTING UNITARY OR COMBINED APPROACH

Senator STONE. This unitary or combined approach, which is in effect in three States, when was the last time that one of those three States adopted that? Is there any movement toward the adoption by any of the other States that you have knowledge of?

Mr. WOODWORTH. It is my impression, but I am not positive of this, that Alaska was the last one to adopt that procedure.

Senator STONE. Do you know how long ago that was?

Mr. WOODWORTH. No, sir, I don't. I am sorry.

Senator STONE. I would appreciate it if you could submit that information for the record.

Mr. WOODWORTH. I will find that out and supply it for the record.

[The information referred to follows:]

ADOPTION OF UNITARY APPORTIONMENT SYSTEMS

[SUPPLIED BY TREASURY DEPARTMENT]

The Alaskan unitary apportionment statute in its present form has been effective only since 1975. However, this statute apparently replaced substantially similar provisions in prior Alaskan law dating back a number of years. The State of Montana appears to have adopted a unitary apportionment system applicable for the first time for taxable years ending on or after Dec. 31, 1974. Unitary apportionment systems have been in effect in California and Oregon for many years, but the system has been applied in California to foreign corporations only since the early 1970's.

It is difficult to determine precise dates for the application of unitary apportionment systems in the states. A number of states, as indicated in testimony before the Committee, have authority in their laws to apply unitary apportionment, or aspects of it, in particular circumstances. If or when this authority is, in fact, exercised is generally a matter of administrative discretion. One cannot tell, therefore, from a survey of state tax laws which state may have most recently adopted the system *and used it*. Nor can such a survey disclose whether there has been any significant movement among the states in regard to the application of unitary apportionment.

Mr. WOODWORTH. One of the problems that we have is the fact that in some cases it is a question of what they do by regulation in determining the profits, rather than the specific statutory provision. That makes it somewhat difficult to trace down and find out precisely when a particular State adopted the system.

That is why I was saying a little while ago that some States use elements of this without using all of it, or even most of it.

Senator STONE. Do the regulations in the three States that have this system by law vary as among the three States?

Mr. WOODWORTH. It is my understanding that they do; yes.

Senator STONE. Is what you are suggesting that in the so-called unitary system detracts from uniformity, even among those States that use it?

Mr. WOODWORTH. Yes.

I am only looking at the international problem. I understand why some States may want to use the systems to trace income between the various States. But it seems to me that once you start applying the system on an international basis, and you find that a few States employ the system while the rest of them do not, you have a very upsetting factor. Also, compliance with the system requires elaborate recordkeeping by corporations. Suppose you have a British corporation, for example, that has a subsidiary in California. Perhaps it has another subsidiary somewhere else in the world. The corporation may think that the non-California businesses are totally unrelated to the business in California. But it is possible for California in that situation to say that they have to see the records of all of that group of corporations' activities throughout the world. In some cases the corporation may not be able to obtain such records. In that case, the State can and does, as we understand it, reconstruct as best they can the records of these other corporations. This leads to a

great deal of arbitrariness in the use of this formula. We think this is disconcerting to international business generally.

BRITISH REACTION TO POSSIBLE RESERVATION

Senator STONE. Could you obtain for the committee from your British counterparts at least their preliminary reaction to the possibility of a reservation? Can they express to us on an informal or preliminary basis the way their government might view such a reservation in connection with a possible reconsideration by Parliament?

Mr. WOODWORTH. You might say that I anticipated that question. I have discussed the matter informally, and I have been informed that this would require reconsideration of the treaty in full under their procedures, and that they would consider the treaty ab initio.

Now they have not indicated to us what that reaction would be. I can understand their point of view.

Senator STONE. But they have said that they would not simply accept the reservation. They would require a review of the whole thing, is that it?

Mr. WOODWORTH. Yes; that is correct.

There are some areas in our relations with the United Kingdom where I think problems could well be caused, but I am reluctant to point them out.

Senator STONE. Thank you, Dr. Woodworth.

Thank you, Mr. Chairman.

Senator CHURCH. Thank you, Senator Stone.

EFFECT OF TREATY ON DOMESTIC UNITARY TAXES

Dr. Woodworth, can you explain to me the effect of the treaty on the unitary tax, where the original purpose of that tax, as you have explained it, was to develop a method for allocating corporate revenues as between the States for businesses that exist in many States, such as large companies? Would the effect of this treaty be to prevent the adoption of unitary taxes limited to domestic concerns?

Mr. WOODWORTH. It would not affect interstate apportionment at all. In other words. States could continue the full application unitary apportionment with respect to the various States. In fact, I assume that they would continue.

Senator CHURCH. Well then, would the effect of the treaty simply be to exempt British-owned companies doing business in this country from the application of the unitary tax?

Mr. WOODWORTH. What it would require is that you use the arm's length method instead of unitary apportionment.

By the way, when most of these estimates that one sees as to how much would be lost are presented, usually they assume that there is no offsetting revenue gain under the arm's length method, which may not be true. What the States would do is simply require that in dealings between the British parent and the subsidiary operating in California, let's say, the allocation of profits would be determined on an arm's length rule of the same type that the Federal Government uses in all operations of this type.

ARM'S LENGTH RULE

Senator CHURCH. How does that arm's length rule differ? You have described the formula for the unitary taxes. Can you describe the arm's length rule?

Mr. WOODWORTH. The arm's length rule requires the tax authorities to look at what would be a price paid by a willing seller to a willing buyer. If the company in question has transactions which are not within the corporate family, you might use the prices that they charge outside of the family in determining the allocation of the profits. If there are no examples of that type, then you would look to see what comparable companies would do in that type of situation.

It is a difficult rule, and I do not mean to imply that it isn't. I would say that any rule in this area is difficult. I think that is the only honest answer that I can give you.

To me, the principal advantage in it lies in the fact that it is the system that is used internationally in this regard.

EXTENT OF TREATY'S IMPACT ON STATE TAXING AUTHORITY

Senator CHURCH. We are just discussing income taxes, are we not?

Mr. WOODWORTH. Yes.

Senator CHURCH. Nothing in this treaty would affect the right of State and local governments to impose ad valorem taxes or excise taxes on such companies, is that right?

Mr. WOODWORTH. Except insofar as the nondiscrimination clause is concerned, which I mentioned before. That is the only other feature that would have any impact at all on State taxing authority.

Senator CHURCH. Thank you.

I think that because of time constraints this morning I would suggest that we place the rest of your prepared testimony in the record so it will be available for the other members of the committee to review, and for our staff.

Mr. WOODWORTH. Fine, Senator.

[Mr. Woodworth's prepared statement follows:]

PREPARED STATEMENT OF ASSISTANT SECRETARY OF THE TREASURY LAURENCE N. WOODWORTH

Mr. Chairman and Members of the Committee: I am very pleased to appear before your Committee today in support of three income tax conventions currently pending before the Senate—treaties with the United Kingdom, Korea, and the Philippines. Two other treaties, with Israel and Egypt, are pending before the Committee but are not being considered at this time.

As tax treaties have not been before this Committee for several years, I would like to take this opportunity to review briefly the purpose and direction of our tax treaty program.

We have income tax treaties currently in force with 23 countries, as well as with a number of former or present British, Belgian, and Dutch colonies to which the treaties with these countries have been extended. In addition to the treaties before you today, and the two others that are still pending, new or revised treaties with a number of additional countries are currently the subject of negotiations.

Besides this rather extensive network of income tax treaties, we also have treaties in force with 13 countries dealing with estate taxes and death duties,

and in a few cases with gift taxes as well. Several other estate tax treaties are now being prepared for signature.

We view tax treaties as an important element in the international economic policy of the United States. One of our fundamental objectives is to minimize impediments to free international flows of capital and technology, and this objective is fostered by having the broadest possible network of income tax treaties.

Among the major impediments to freer capital and technology flows are the rules of national tax systems and their interaction with the systems of other countries. Tax treaties seek to eliminate, or a least mitigate the impact of, these impediments.

Treaties accomplish this minimization of impediments by a variety of means, the principal ones being the elimination or reduction of double taxation and the elimination, to the extent possible, of discriminatory tax rules which distinguish unreasonably between domestic and foreign investment.

At the same time, tax treaties also serve other policy objectives—for example, the prevention of tax avoidance and evasion, and the fostering of international cooperation between the tax authorities of Contracting States.

You will see, I believe, as I discuss the treaties currently under consideration, how their individual provisions bring about the harmonization of tax systems with resultant benefits for the United States.

Each of the treaties before you was negotiated by the Treasury Department in close consultation with the Department of State.

In the case of the United Kingdom, the proposed treaty would replace the existing treaty which was signed in 1945 and amended by four subsequent protocols, the most recent of which was signed in 1966. In the other two cases, the proposed treaties would be the first to be entered into by the United States with the treaty partner.

In their general form and many of their specific provisions, these three treaties are alike. However, each of them contains special and in some cases unique provisions, which I will discuss in detail in what of necessity is a rather lengthy statement.

Tax systems differ from country to country as do bilateral economic relations. Modifications in our standard treaty format are necessary in order to accommodate these differences. Although we enter each negotiation with the goal of achieving all of our objectives, we must sometimes accept the benefits of a good treaty when a perfect treaty is simply not attainable. Therefore despite the fact that our treaties retain a common structure and policy thrust, they invariably differ from one to another.

Let me deal first with a general overview of the treaties before you. The one with Korea was negotiated in 1973 and negotiations with the Philippines were begun at about that time. These treaties therefore reflect the model treaty which the United States was then using as a basis for discussions. In 1975 we revised our model treaty to bring it more closely into conformity with the Model Income Tax Treaty of the Organization for Economic Cooperation and Development (OECD). The revised U.S. model was used as a basis for our discussions with the United Kingdom, and, as a result, you will observe differences in form between the United Kingdom treaty and the others. We do not believe that these formal differences represent major differences in substance.

There are also differences among the three treaties reflecting differences among these countries in levels of economic development. Although we do not offer tax sparing, we do modify some treaty provisions, without altering our basic policies, to reflect the development, revenue, and foreign exchange needs of developing countries. These modifications are to be found principally in the permanent establishment, business visitor, and investment income withholding provisions.

The need of developing countries for revenue often leads them to enact statutory rules which are so burdensome as to inhibit investments. We try by treaty to bring both the levels and scope of such taxes within internationally accepted norms. We recognize, however, that developing countries' have legitimate revenue needs, and we therefore seek reduction in withholding tax rates only to levels which would make these taxes creditable in th U.S. rather than

to levels which would result in transfers of revenue from the foreign treasury to the U.S. Treasury.

The treaties before you today have many features in common. Each of them, for example, includes the standard treaty rule stating that a resident of one State will not be subject to tax on business profits in the other State unless these profits are attributable to a permanent establishment which the resident maintains in the other State. By limiting taxation to situations where there is more than just a casual economic contact, we can remove a major irritant to the free flow of international commerce. Though this general rule is standard, there are some differences among the treaties in the definitions both of permanent establishment and business profits.

Each of these treaties also provides that residents of one country who temporarily visit the other for business or educational purposes will not be subject to tax in the host country on income derived there unless they have a significant economic contact with that country in terms of time spent or income earned. As in the case of permanent establishment rules, the degree of contact that we require with developing countries tends to be somewhat less than that required in treaties with developed countries.

As with almost every tax treaty, each of the treaties under consideration establishes maximum levels of withholding tax on dividends, interest, and royalties paid from the source country to residents of the other country. The aim here is to make taxation a relatively neutral factor in investment decisions. Dividend, interest, and royalty provisions probably affect more taxpayers than any other treaty provisions.

It is United States treaty policy, reflected in the treaties under consideration today, that each Contracting State may tax its residents and nationals as if a treaty had not come into effect. The only exceptions to this rule relate to provisions which are clearly intended to limit the authority of a Contracting State to apply its internal tax law to its citizens and/or residents. For example, the treaty foreign tax credit provisions give assurance that, irrespective of changes in internal law, a Contracting State will permit credit for taxes properly imposed by the other Contracting State.

We view an income tax treaty as more than a resolution by the Contracting States of specific substantive problems. There must also be a commitment not to discriminate in tax matters, and to attempt to solve problems not directly dealt with by the substantive provisions of the treaty. All of our recent treaties include a prohibition against discrimination, and all provide for consultation and administrative assistance between the tax authorities of the Contracting States. The importance and value of these provisions are, I believe, being increasingly recognized by both taxpayers and tax administrators.

The Treasury has prepared technical explanations describing in detail each of the three treaties. I would like to submit these for the record and to turn, at this time, to the highlights of each individual treaty.

U.K. TREATY

The proposed treaty with the United Kingdom was signed on December 31, 1975. In early 1976, however, several technical problems came to light. Amendments to the text to deal with these problems were agreed to in April 1976, and the proposed treaty was restated to incorporate these amendments before it was submitted to the Senate.

A protocol was signed in August 1976 making further amendments, largely technical in nature, dealing with corporations resident in both countries, the treatment of shipping income, and the calculation of the U.S. foreign tax credit on dividends received from U.K. corporations. A second protocol was signed on March 31, 1977, principally to deal with a problem arising from a provision in U.K. internal law relating to the determination of British domicile. In my statement I will discuss the restated treaty as amended by the two protocols.

This treaty is, I believe, quite significant. Our economic relations with the U.K. are close and extensive. U.S. direct investment in the U.K. at the end of 1975 totalled $14 billion and U.K. direct investment in the U.S. was $7 billion. During 1975 U.S. investors received over $1 billion in dividends, interest,

branch profits, and royalties from this investment. U.S. payments to U.K. investors totalled over $350 million.

Moreover, this treaty is important in principle because it breaks new ground in several fundamental respects.

DIVIDENDS

The dividend provision of the U.K. treaty reflects a major concession by the British. To understand this provision, it is necessary to outline the United Kingdom system for taxing corporations and their shareholders.

In 1973 the U.K. introduced a partially integrated system under which a portion of the tax collected at the corporate level is treated—with respect to distributed profits—as having been paid on behalf of resident individual shareholders.

Under the U.K. system, U.K. corporations are subject to an initial corporate tax liability of 52 percent. When a dividend is paid, a tax called the Advance Corporation Tax (or ACT) is levied. This ACT is equal to 35/65 of the net dividend and it is credited against the corporation's regular year-end tax liability.

An individual U.K. resident shareholder pays tax not only on the dividends but also on the ACT paid with respect to the dividend. However, he may claim a credit against his own income tax liability for the ACT. If he is a "standard rate" taxpayer subject to a 35 percent rate, the credit will exactly offset his tax on the dividend income. If he is subject to tax below the standard rate, he will receive a refund of the excess of the ACT credit over his tax due. Thus, for a U.K. resident, the ACT is clearly a prepayment at the corporate level of the shareholder's tax.

When the shareholder is a U.K. corporation, the general rule is that the ACT is paid and the recipient corporation is not subject to tax on the dividend income. When that corporation, in turn, pays a dividend to domestic individual shareholders out of this dividend income, there is no further ACT to be paid and the ACT paid on the original dividend passes through and attaches to the second dividend. Alternatively, the first corporation may elect not to pay the ACT in the case of dividends to a related domestic company, but in this case the second corporation becomes liable for payment of the ACT when it pays that income out as a dividend to individual shareholders.

However, when the shareholder is a nonresident alien, the situation is quite different. British law provides that the ACT must be paid upon any distribution, but there is no credit or refund allowed to the nonresident shareholder—corporate or individual.

This treatment discriminates against U.S. investors in the U.K., since for U.K. shareholders the effective underlying corporate tax rate with respect to distributed profits is just over 26 percent (after allowance of the ACT credit) while, in the absence of this treaty, for nonresident shareholders the rate remains at 52 percent. This discrimination is potentially of significant dollar magnitude, and must be viewed as a serious problem. We concluded that an income tax treaty is probably the only appropriate vehicle for mitigating the discrimination.

The new U.K. system is not a unique or isolated phenomenon, but rather is likely to be the prototype for European tax systems generally. A June 1975 draft directive of the Commission of the European Economic Community calls for adoption of similar integrated corporate/shareholder tax systems by all Common Market countries. Such a system has been in place in France for some time, and the new tax law in West Germany follows a similar approach. It is, therefore, apparent to us that a precedent must be established early if we are to deal effectively in subsequent negotiations with other countries employing integrated systems. This fact may have led to Britain's initial reluctance to deal with integration-caused discrimination at the present time, while EEC policies with respect to this issue are still in a formative stage.

Under the rules of Article 10 (Dividends) and Article 23 (Elimination of Double Taxation) of the proposed treaty, the discrimination is substantially reduced. For U.S. portfolio shareholders (defined as any shareholder except a

corporation which owns at least 10 percent of the voting stock of the paying corporation), the treaty provides the same credit as that available to a U.K. shareholder. It envisions that the ACT part of the U.K. corporate tax will be refunded directly to the U.S. shareholder and, for U.S. tax purposes, be treated as part of the shareholder's dividend income. The total dividend is then subject to the withholding rate provided for in the treaty for portfolio dividends: 15 percent. Thus, on a cash dividend declared of $65.00 the shareholder is entitled to a gross refund of $35.00. From the total dividend of $100.00, the U.K. withholds 15 percent or $15.00, and the U.S. shareholder receives $85.00. For U.S. tax purposes, the shareholder includes the full $100.00 in income and receives a foreign tax credit against his U.S. tax for the $15.00 withheld by the U.K.

For portfolio shareholders the proposed system is essentially the same as the rule which has been in effect in our treaty with France since 1970. It is also the same as the provisions which the U.K. has included in a number of their recent treaties. It is provided in the proposed U.K. treaty that this system will be followed as long as the ACT credit is allowed domestically in the U.K.

The proposed treaty, for the first time in any income tax treaty, also provides a rule for mitigating the integration-related discrimination against direct investors—i.e., those U.S. corporations which own at least 10 percent of the voting stock of a U.K. corporation. The treaty provides that when a dividend is paid by a U.K. corporation to a U.S. direct investor, a refund equal to one-half of the credit allowable to a U.K. domestic shareholder, i.e., one-half of the ACT, is paid to the U.S. investor. From the gross dividend (the cash dividend paid plus the ACT refund) an amount equal to 5 percent is withheld by the U.K. On a cash dividend of $65.00 paid to a U.S. direct investor, the refund from Inland Revenue would be $17.50. The amount withheld on the total dividend of $82.50 would be $4.12. The net refund therefore would be $13.38, and the parent corporation would receive $78.38.

I would like to explain why the refund paid to direct investors differs from that paid to portfolio investors. The basic premise of an imputation system is that corporate and individual income taxes are integrated. As long as profits remain in corporate solution there is no reason to allow a credit. This is reflected in the U.K. internal tax system, under which the ACT credit is not allowed to corporate recipients of dividends. However, under that internal tax system, the credit passes through a U.K. parent corporation and is allowed to U.K. individual shareholders when the profits leave corporate solution. A U.S. shareholder investing in the U.K. through the intermediary of a U.S. parent corporation would enjoy none of the benefits provided for in the U.K. statute. Using a rule of thumb that about one-half of U.S. corporate profits are paid out in dividends, agreement was reached by treaty to extend one-half of the credit to U.S. direct investors, on the assumption that this credit relates to that portion of the U.K. dividend which on average will eventually be passed through to U.S. shareholders. This resolution provides a measure of fairness for U.S. investors and does no violence to the concept of an integrated system.

The table which follows illustrates the operation of these treaty provisions for both U.S. direct and portfolio investors.

On U.S. source dividends paid to residents of the United Kingdom, there is, of course, no U.S. refund. In general, the U.S. witholding rate is reduced to 15 percent, except that when a dividend is paid to a direct investor in the U.K., the U.S. tax is limited to 5 percent. These are the same withholding rates applied by the U.K. If, while the treaty is in force, the U.K. should abandon its domestic dividend credit mechanism, the U.K. witholding rates will remain at 15 and 5 percent but the provisions dealing with the refund and credit would not be applicable.

UNITARY APPORTIONMENT TAXATION

One provision of the pending treaty with the United Kingdom—paragraph 4 of Article 9—has generated a great deal of controversy and has been the subject of some misunderstanding. That provision seeks, under certain restricted circumstances, to limit the application of unitary apportionment rules in those states which employ such rules.

ILLUSTRATION OF UNITED STATES-UNITED KINGDOM TREATY PROVISIONS WITH RESPECT TO UNITED KINGDOM DIVIDENDS RECEIVED BY UNITED STATES PARENT CORPORATION AND UNITED STATES INDIVIDUAL SHAREHOLDER

	50-pct dividend	100-pct dividend
United Kingdom corporation:		
1. Pretax corporate profits	100.00	100.00
2. Less: Initial corporation tax liability (52 pct)	52.00	52.00
3. Amount available for distribution	48.00	48.00
4. Net dividend declared	24.00	48.00
5. ACT paid (35/65×(4))	12.92	25.85
United States parent corporation:		
6. ACT refunded before withholding	6.46	12.92
7. Less: Amount withheld (5 pct×(4)+(6))	1.52	3.05
8. Net ACT refund	4.94	9.87
9. Net United Kingdom corporation tax ((2)−(6))	45.54	39.08
10. Total cash received ((4)+(8))	28.94	57.87
11. Plus: Amount withheld (line (7))	1.52	3.05
12. Plus: 902 gross-up $\frac{(4)+(6)}{(1)-(9)}\times(9)$	25.47	39.08
13. United States taxable income ((10)+(11)+(12))	55.93	100.00
14. United States tax before credit (48 pct×(13))	26.85	48.00
15. Less: Foreign tax credit ((11)+(12))	26.99	42.13
16. Net United States tax (excess credit)	(.14)	5.87
17. Dividend income after tax ((10)−(16))	28.94	52.00
United States individual shareholder:		
18. ACT refunded before withholding	12.92	25.85
19. Less: Amount withheld (15 pct×(4)+(18))	5.54	11.08
20. Net ACT refund ((18)−(19))	7.38	14.77
21. Total cash received ((4)+(20))	31.38	62.77
22. Plus: Amount withheld (line 19)	5.54	11.08
23. United States taxable income ((21)+(22))	36.92	73.85
24. United States tax before credit (45 pct, for example)	16.61	33.23
25. Less: Foreign tax credit (line 22)	5.45	11.08
26. Net United States tax	11.07	22.15
27. Dividend income after tax ((21)−(26))	20.31	40.62

DESCRIPTION OF THE UNITARY APPORTIONMENT SYSTEM

There are just a few states which employ the unitary apportionment system—principally California, Oregon, and Alaska—though the laws of certain other states provide for selective application of some elements of unitary apportionment. The specific details of the system may differ somewhat from state to state. Since California is the most significant of these states in terms of international business activities, my description today is based on the California system.

When a single enterprise is doing business both inside and outside California, income is apportioned to California under the traditional three-factor formula (payroll, property, and sales). However, when an enterprise doing business in California controls other corporations, is itself controlled by another corporation, or is related to other corporations by virtue of common ownership, and when the degree of common ownership or control is over 50 percent, California requires the controlled group to file a combined report of the group's worldwide income. A combined report is required regardless of whether the parent company or brother-sister companies do business in California, as long as the group constitutes a "unitary business" under California's rules. A unitary business generally exists when there is (1) a unity of ownership (common ownership); (2) a unity of operation as evidenced, for example, by central purchasing, advertising, accounting, and management, and (3) a unity of the use of a centralized executive force and general system of operation. Alternatively, a business will be treated as unitary if the operation of that part of the business carried on in the state is dependent on, or contributes to, the part which is carried on outside the state.

California tax authorities appear to construe the definition of a unitary business very broadly, so that related entities which appear to be independently engaged in very different kinds of activities are aggregated into a unitary business and must be included in a combined report to the tax authorities.

The combined report is, in effect, a consolidated return of the controlled group's worldwide income, although separate returns may be made for each member of the group. California apportions income to the state on the basis of the proportions which the California assets, sales, and payroll bear to the worldwide assets, sales, and payroll of all the related companies.

In the context of multinational business operations, California does not limit its requirement of a combined report to enterprises which are California or United States controlled. For several years now, affiliated groups of corporations having a foreign parent and a California subsidiary have been required to file a combined report if the business has a "unitary" character.

BACKGROUND OF THE TREATY PROVISION

Over the past several years, a number of our treaty partners have raised the question of state application of unitary apportionment systems to multinational corporate groups based in their countries. They have made essentially two points. First, they note that our income tax treaties clearly provide that one Contracting State may not tax the business profis of an enterprise which is a resident of the other State unless those profits are attributable to a permanent establishment in the first Contracting State. They perceive the California system as taxing profits which are earned outside California and not attributable to a permanent establishment located in California. Our treaty partners recognize, of course, that this California practice does not violate the business profits provisions of our existing treaties, because existing treaty provisions apply only with respect to the Federal income tax. Nevertheless, they maintain that state unitary apportionment systems, as applied to foreign corporations, do violate the spirit of our agreements.

Secondly, foreign governments have noted the severe administrative burdens which unitary apportionment systems impose on their corporations. A substantial amount of financial and operating data from each affiliate (in effect the data necessary for a full tax return) must be included in the combined report of the group. When members of the group, and particularly the parent corporation, are located abroad, much of this information is either difficult or impossible for the taxpayer to obtain. Foreign parent corporations find it extremely burdensome to submit all of their books and records concerning all of their worldwide activities in a form satisfactory to the taxing state. This is especially true when only one of a large number of their affiliates does business in the state and the books and records are kept in different languages, different currencies, and according to different sets of accounting rules.

REASONS FOR TREATY PROVISION

There are several reasons, both substantive and administrative, why the Treasury believes that the application of the unitary system should be limited as it applies to foreign corporations.

Those states which employ the unitary system see it as a logical extension of the standard use of the three factor formula. It is also viewed as a means of dealing with efforts by groups of related corporations to manipulate income and expenses to the detriment of the state treasury. This is a legitimate concern of both Federal and state governments. The treaty, however, deals explicitly with this issue. Paragraph 1 of Article 9 provides for the adjustment of accounts between related persons to reflect the income and expenses which would be recorded if the related persons were dealing at arm's-length.

And Paragraph 4 of Article 9 is very clear that it does not prevent Federal or state governments from making the arm's-length adjustments provided for in paragraph 1.

In this connection I would note that the arm's-length standard is the internationally accepted norm for apportioning income between related taxpayers. It is confusing to other countries and disconcerting to international relations when our states use a different standard. Furthermore, the use of a different method by one jurisdiction will often lead to double taxation. We recognize that the purpose of the unitary system is not to tax the income of the foreign corporation included in the group, but the effect, nevertheless, is often extra-territorial taxation.

Though the administrative resources available to state governments may not permit them to make the same kind of intensive transfer price investgations that the Federal tax authorities are able to make, individual states have access to materials developed by the Internal Revenue Service in its investigations of cases where related companies may not be pricing according to an arm's-length standard.

Moreover, the unitary apportionment system as a means for determining the state taxation base of a multinational corporation is highly imperfect and a poor substitute for the arm's-length standard. Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. And when it is not the case, the unitary system will misallocate income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system allocates too much income to the domestic member or members of the group. The result is tantamount to taxation by a state government of the foreign income of a foreign corporation.

The misallocation of the tax base under the application of unitary apportionment to foreign corporations can occur for several reasons. For example, labor costs vary substantially among countries—very much more so than among regions in the U.S. If two affiliates, one in California and one in, say, Hong Kong, are engaged in essentially the same activities, the Hong Kong labor cost element in the formula will probably be lower than the California labor cost. A disproportionate amount of income will be apportioned to California. Changes in exchange rates can have a similar effect.

Some state governments have suggested that the treaty provision will result in a large revenue cost to unitary taxation states. If, in fact, there is a substantial revenue loss when an arm's-length pricing standard replaces unitary apportionment, this may be an indication that unitary apportionment does, in fact, result in injustifiable extraterritorial taxation.

We also perceive a major problem in the extensive information required by the tax authorities applying unitary apportionment systems. If the necessary information is not provided by the taxpayer, the state authorities reconstruct accounts on the basis of whatever information they can obtain from public sources, such as reports to shareholders. Tax liability calculated on the basis of such reconstructed accounts is, at best, arbitrary, and may very well be unfair. If the parent corporation operates in the taxing state, it is of course possible for the taxpayer to provide accurate information and avoid an arbitrary result. But if the taxpayer is a subsidiary of a foreign parent corporation, or stands in a brother-sister relationship to a foreign affiliate, the submission of accurate data may not be within the taxpayer's power.

The Administration is not alone in considering the issues raised by the unitary system. Legislation, known as the Jones Amendment, was proposed in the House during this past Congress, and would exclude all foreign corporations from states' unitary tax bases. The Jones Amendment was referred to a special task force of the Ways and Means Committee on foreign source income. The task force, chaired by Congressman Rostenkowski of Illinois, has recommended that "States be precluded from taking into account, under the unitary method or under any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income is subject to Federal income tax."

DESCRIPTION OF THE U.K. TREATY PROVISION

The treaty will affect the tax jurisdictions of states to only a limited extent. It provides that a state, say California, in assessing the income of an enterprise doing business there, may not take into account any income or expenses of a related foreign company which is related to a U.K. enterprise. The state may, however, take into account income and expenses of any related U.S. companies, income of all branches of U.S. companies, and income of U.K. companies doing business in California.

The treaty rule will apply if the following conditions are met:

1. The enterprise doing business in California must be either a resident of the U.K. or be controlled, directly or indirectly, by a U.K. resident.

2. Where the U.K. resident is a corporation, such corporation must be neither controlled by a U.S. corporation nor by a corporation which is a resident of a third state.

3. No U.K. or third country enterprise which is related to a U.S. subsidiary doing business in California would be excluded from California unitary apportionment calculations under the treaty if that enterprise is controlled by the U.S. subsidiary.

A few examples may clarify how the rule would operate:

If a subsidiary of a U.K. corporation is doing business in California, and that U.K. parent corporation has subsidiaries in France and Germany, California would be prohibited from including in its unitary apportionment base the income or expense of the U.K. parent or of its subsidiary corporations in France or Germany

However, if the U.K. corporation is itself controlled by, say, a New York corporation, or by a Dutch corporation, California may take into account the income and expense of the entire group—the U.K. corporation, the French and German subsidiaries, and the Dutch or New York parent.

If the California subsidiary of the U.K. corporation has a subsidiary of its own in, say, Belgium, the U.K. parent and the French and German sister corporations may not be included in the unitary apportionment calculations by California, but the Belgian subsidiary, even though it is related to the U.K. corporation, may be taken into account.

OTHER PROVISIONS

There as several other issues raised by this treaty which I would like to touch on briefly.

U.S. CITIZENS RESIDENT IN U.K.

A combination of provisions in our existing treaty with the United Kingdom led the British courts to conclude, in what has come to be known as the Lady Strathalmond decision, that the United Kingdom was precluded from taxing U.K. residents who are U.S. citizens on dividend and interest income from U.S. sources. This wholly unintended benefit for U.S. citizens resident in the U.K. stood to cost the United Kingdom substantial amounts of revenue.

In addition, the Strathalmond decision introduced an asymmetry into the taxation rights granted by the treaty. U.S. residents who are U.K. nationals are subject to U.S. tax on their global income. However, U.K. residents who are U.S. citizens who receive investment income from the U.S. were not, by virtue of Strathalmond, subject to U.K. tax on their global income. The treaty before you today corrects this asymmetry.

U.K. WIVES PROBLEM

The correction of the problem raised by the Strathalmond decision brought to light another issue, arising out of the U.K.'s internal law provisions for determining domicile. Although this is not a traditional tax treaty issue, the British agreed to deal with it, and this was the principal purpose of the second protocol, signed on March 31, 1977.

Under British law in effect prior to 1974, an individual who became a U.K. resident could easily retain a foreign domicile. The principal exception was that a married woman automatically acquired her husband's domicile. Thus, a woman who was a U.S. citizen and who could, under normal U.K. standards, be considered to have a foreign domicile would, if she was married to a U.K. domiciliary, automatically be considered as having a U.K. domicile. This rule was changed in 1974, but the change applied only for women married after 1973.

A British domiciliary is subject to higher U.K. taxes on foreign source income than a foreign domiciliary. Under the Strathalmond decision this distinction had no serious effects because a U.S. wife of a U.K. domiciliary would not be subject to U.K. tax on her U.S. source investment income even though she was domiciled in the U.K. Under the proposed treaty, however, she would be subject to U.K. tax, and the distinction between U.K. domicilaries and nondomicilaries becomes important. A number of women in this position complained that the U.K. rule on domicile discriminated against women and that the proposed treaty condoned this discrimination.

The discrimination is eliminated now by a provision that, for purposes of determining domicile, the marriage of a woman who is a national of the United States shall be treated as having taken place on 1 January 1974. Under this provision, she would be able, if the facts warrant, to establish a non-British domicile independent of her husband's domicile.

DUAL-RESIDENCE COMPANIES

In general, our treaties seek to assign a unique residence, in one or the other country, to all persons subject to the treaty. In the proposed treaty with the United Kingdom we were not able to agree on such a rule for corporations which each country considers resident of that country. Under British law a corporation is resident where it is managed and controlled. Under U.S. law a corporation is resident where it is incorporated. A corporation organized in the United States but managed and controlled in the United Kingdom would, therefore, be a dual resident. Neither side was willing to make its test of residence subsidiary to the other, and an entity which has dual residence under the treaty could combine the benefits of residence in both countries so as to receive unjustified advantage. We agree, therefore, that with the exception of certain provisions, dual resident corporations would be denied the benefits of the treaty. While this appears to be a harsh result, we must bear in mind that, given the nature of the two tests of residence, a dual resident corporation may extract itself from the situation.

PETROLEUM REVENUE TAX

The British recently introduced a tax, called the Petroleum Revenue Tax (PRT), on petroleum production activities on its continental shelf. The British asked that we specifically cover this tax in the treaty so that U.S. companies will be assured of a foreign tax credit in the United States for the PRT. Article 2(2)(b)(Taxes Covered) specifies that the PRT is included in taxes covered. Article 23 (Elimination of Double Taxation) notes in paragraph (1)(a) that the taxes covered in Article 2(2)(b) are to be treated as income taxes for purposes of the U.S. foreign tax credit.

The special limitations in section 907 of the Internal Revenue Code relating to foreign oil and gas income apply with respect to the PRT.

ENTERTAINERS

Article 17 (Artistes and Athletes) provides, in paragraph 1, that an entertainer or athlete may be taxed by the Contracting State in which his services are performed unless the remuneration for those services, including expenses reimbursed to him or borne on his behalf, does not exceed $15,000 in the year concerned.

Paragraph 2 of Article 17 is designed to deal with an entertainer or athlete arranging for a part or all of the income for his services to be paid to another person, including a corporation or trust, so as to avoid tax in the host country. If that other person is a foreign corporation which does not have a permanent establishment in the host country, the income would, under normal treaty rules, be completely free of tax in the host country. Paragraph 2 prevents this abuse of the treaty by providing that when the income from an entertainer's or an athlete's activities does not accrue directly to him, but to another person, that person will be subject to tax despite the limitations which would otherwise be applicable under the business profits or personal services articles of the treaty.

If the entertainer does not participate in any way in the profits earned by the other person, such as by the receipt of deferred remuneration, dividends, or partnership distributions, then the provisions of paragraph 2 will not apply.

Article 17 reflects the view, widely held among both developed and developing nations, that the taxation of entertainers and atheletes presents special problems. Although the Treasury does not agree that such persons are wholly different from others performing personal services, we do recognize that the circumstances under which their income is earned can often be extraordinary: it is not uncommon, for example, for entertainers and athletes to earn large sums in a very brief period of time spent in the country of source.

Our views on this issue, and in specific regard to Article 17, are set forth in detail in a letter dated March 1, 1977 which I addressed to Senator Javits. I would like to submit this letter for the record at this time.

INTEREST AND ROYALTIES

In addition to the maximum withholding rates prescribed in Article 10 for dividends, which I have already described, Articles 11 and 12 of the treaty provide for exemption from withholding in the source country on interest and royalties, respectively, paid to residents of the other Contracting State.

KOREAN TREATY

The treaty with Korea was signed on June 4, 1976. There is very little in this treaty that requires special comment.

SOCIAL SECURITY EXEMPTION

One provision not found in any other U.S. treaty appears in Article 25, which provides a special exemption from U.S. social security taxes for Korean residents who are temporarily present in Guam. A simlar exemption is provided in the Internal Revenue Code for Philippine residents temporarily present in Guam. The Koreans argued that the Philippine exemption provides an unfair advantage to Philippine residents and the firms which hire them. They asked that a similar exemption be written into the treaty for Korean residents. The treaty provides that Korean residents will be exempt from social security taxes in Guam only so long as the statutory exemption is in effect for Philippine residents. This provision of the treaty was negotiated in consultation with the Department of Health, Education and Welfare.

It is more reasonable to put these Korean workers on a par with the Philippine workers, with respect to social security tax liabilities, than with workers who are resident in Guam or the United States. The latter groups are subject to social security taxes but they are also eligible for benefits. The workers from Korea and the Philippines are typically present in Guam for only one year and therefore are not likely to be eligible for social security benefits.

INVESTMENT INCOME PROVISIONS

The treaty establishes maximum rates of withholding tax in the source country or income payments flowing between the two countries. Under Article 12, the rate of withholding tax on portfolio dividends is limited to 15 percent, while on dividends paid by a subsidiary to a parent corporation the rate of tax may not exceed 10 percent. The maximum rate of withholding tax established on interest in Article 13 is 12 percent, except that interest derived by the Government of one of the Contracting States, or by its local authorities or instrumentalities, is exempt from withholding at the source. Under the terms of Article 14, royalties are subject, in general, to a 15 percent maximum rate of tax. However, the tax on literary and artistic royalities, including motion picture royalties, is limited to 10 percent.

EXCHANGE OF NOTES

Notes were exchanged by the U.S. and Korea at the time of the signing of the treaty which deal with two subjects—treaty incentives for investment in Korea, and the Korean Defense Tax. During the negotiations, Korea expressed its desire to have included in the treaty special provisions to promote the flow of U.S. capital and technology to Korea. The U.S. note recognized this desire and offered assurances that, when circumstances permit, the U.S. would be willing to reopen discussions on provisions which would "minimize the interference of the United States tax system with incentives offered by the Government of the Republic of Korea." Any such provisions, the note continues, would be consistent with U.S. tax policies regarding other developing countries. This note is the same in substance as one signed in 1970 at the time of the signing of our income tax treaty with Trinidad and Tobago.

The Korean Defense Tax is a enacted series of surcharges on a variety of existing Korean taxes, including the income and corporation taxes—the taxes covered by the convention. The Korean note confirms that the taxes covered by the treaty, as designated in Article 1, includes those parts of the defense tax which are related to the income and corporation taxes. This means that under the treaty any U.S. resident who is exempt by treaty from Korean income or corporation tax is also free of any related Defense Tax liabilities.

PHILIPPINE TREATY

The treaty with the Philippines was signed on October 1, 1976. An earlier treaty with the Philippines was signed on October 5, 1964 and approved by the Senate with reservations on several provisions. That treaty was never ratified by the Philippine Government.

SHIPPING AND AIRLINE PROFITS

The treaty does not contain the usual reciprocal exemption of shipping and airline profits. We tried very hard to include a reciprocal exemption provision. However, the Philippines is strongly opposed to such an exemption on revenue grounds, and has not agreed to it in any other treaty. They did agree to reduce their income tax by treaty from 2½ percent of "gross Philippine billings" (which on passenger travel includes any tickets sold in the Philippines) to 1½ percent of gross receipts on outbound traffic from the Philippines. Moreover, they would guarantee in the treaty to reduce the rate below 1½ percent if they agreed to a lower rate in a treaty with another country. The Philippines has signed treaties with the United Kingdom and Canada which contain a similar provision. We, too, tentatively agreed, and then we discussed it with the affected U.S. companies. Only Pan American Airways objected. Pan Am feared the precedent of treaty approval of any level of tax, and indicated that in the absence of exemption, they would prefer to be left out of the treaty. The other U.S. airlines agreed to support Pan Am's position, although the treaty would have clearly benefitted TWA, which does not fly to the Philippines but does make ticket sales there which are taxable under the law and would not have been by treaty. The treaty rule would probably also have benefitted Northwest and Flying Tiger Lines, both of which fly to the Philippines. We made a final attempt to persuade the Philippines to grant a reciprocal exemption and when that failed we asked them to delete airlines from the treaty. The Philippine negotiators were puzzled that a higher tax would be preferred to a lower tax, but they agreed to the deletion. I believe we could, however, if the Senate so advises, ask the Philippines to reinstate airlines in a protocol to the treaty, subject to a maximum tax of 1.5 percent of gross receipts on outbound traffic or any lower rate agreed to by the Philippines in a treaty with a third country.

NONDISCRIMINATION

Article 24 of the treaty affirms the principle of nondiscriminatory tax treatment with respect to all taxes but there are certain exceptions. These exceptions allow the Philippines to reserve to Philippine nationals incentives granted under specific sections of existing law. These sections permit: (1) a deduction for certain amounts invested in new shares of pioneer industries and a shorter holding period to qualify for capital gains treatment on the sale of such shares; (2) a deduction for certain local costs of export production to firms which are 60 percent Philippine owned; and (3) limited incentives to investment in tourist facilities.

PERSONAL SERVICE INCOME

Income derived by a resident of one country from performing personal services, other than entertainment services, in the other country is exempt from tax by that other country unless the individual remains there 90 days or longer during the year or, in the case of services performed in an independent capacity, unless the gross remuneration exceeds $10,000 or a higher amount agreed to by the tax authorities of the two countries. (Although gross remuneration determines whether a tax liability arises, the tax would be imposed on net income). The 90-day period is consistent with the U.S. statutory rule concerning employees of foreign companies in the United States.

The conditions for exemption of entertainers performing services in the other country are that the income for such services not exceed $100 per day or $3,000 per year. This is similar, in essential respects, to the provisions in our 1970 treaty with Trinidad and Tobago.

INVESTMENT INCOME PROVISIONS

The treaty establishes maximum rates of withholding tax in the source country on income payments flowing to residents of the other country. The treaty reduces the statutory rates of 30 percent in the United States and 35 percent in the Philippines. The maximum rate of withholding tax under the treaty is 25 percent on portfolio dividends and 20 percent on dividends paid to a parent corporation owning 10 percent or more of the voting shares. The 20 percent limit applies also to the additional Philippine tax on profits of U.S.

corporations derived through Philippine branches. Since the Philippine corporate tax rate is 35 percent these limits should ensure that the Philippine tax will be fully creditable to U.S. corporations.

The treaty provides a maximum tax at the source of 15 percent on interest in general, 10 percent on public bond issues, and exemption of interest paid to the Government of one of the Contracting States or an instrumentality thereof, or interest on debt guaranteed or insured by that Government or instrumentality.

In the case of royalties the treaty provides a limit of 15 percent at the source for the United States. The Philippine tax at source is also limited to 15 percent provided that the paying corporation is registered with the Board of Investments and engages in preferred areas of activity. In other cases the Philippine tax is limited to 25 percent or to a lower rate if a lower rate applies on comparable payments to residents of third states. This most-favored nation provision means that the Philippine tax on film rentals will be 10 percent, because that rate appears in the Philippines treaties with Sweden and Denmark. The Philippines agreed not to tax rentals of tangible property as royalties.

CONCLUSION

I believe that the addition of the two new treaties—with Korea and the Philippines—to our growing network of income tax treaties and the modernization of our treaty with the United Kingdom, to permit it to better serve our current needs, will strengthen our economic relations with these three countries.

The United Kingdom is one of our major trading partners with whom we have shared close economic ties for many years. We are pleased to have this opportunity to update and revitalize our tax treaty arrangements.

The United States today has only two treaties in force with developing countries—treaties with Pakistan and Trinidad and Tobago. We attach importance, therefore, to the expansion of our treaty network to include Korea and the Philippines.

This Committee has the opportunity now, by approving these three treaties, to make a clear and strong statement in support of the policies which they reflect—as well as our general policy of seeking a broadening network of income tax treaties.

I urge your approval of these three treaties.

EXPLANATION OF CONVENTIONS

Mr. WOODWORTH. We have also a technical explanation of the conventions.

Senator CHURCH. I would like very much to have that explanation, and it should also be included in the record. The newspaper clipping you have referred to should be included in the record.

Mr. WOODWORTH. All right, I would be glad to do that. We have also correspondence with Senator Javits on a part of the treaty which has not been described. This might be useful to place in the record also.

Senator CHURCH. Do you describe that part of the treaty in that?

Mr. WOODWORTH. The letter concerns the article dealing with the tax treatment of entertainers and athletes. It deals with the provision in the U.K. treaty that where the gross receipts received by an entertainer or athlete do not exceed $15,000, the income will not be taxed in the source country, where the services are performed, but rather it would be taxed in the country of citizenship or residence of the individual receiving the income. Generally speaking, apart from these provisions, the income would be subject to the laws of the source country to the full extent that their laws might so provide. The letter contains a much more elaborate description than this, but I think that indicates the issue generally. [See appendix, p. 375.]

Senator CHURCH. So there would be a $15,000 exemption each year for athletes in host countries, earning income there?

Mr. WOODWORTH. Yes. In other words, where the amount an American entertainer or athlete receives is not over $15,000, the source country would exempt. Most of the complaints we have heard about this relate to the $15,000 limitation. In other words, an American entertainer or athlete over there is taxed in the United States under our law, but if the amount received is not more than $15,000, it is not taxed in the other country.

Senator CHURCH. Thank you very much, gentlemen, for your testimony.

Mr. WOODWORTH. We have also the explanation of the other two treaties which I will submit for the record [See appendix, p. 318.]

Senator CHURCH. Our next witness is Mr. Paul J. Oosterhuis, who is the Legislation Counsel for the Joint Committee on Taxation. He is accompanied by David Brockway, Legislation Attorney for the Joint Committee on Taxation.

STATEMENT OF PAUL J. OOSTERHUIS, LEGISLATION COUNSEL, JOINT COMMITTEE ON TAXATION, ACCOMPANIED BY DAVID BROCKWAY, LEGISLATION ATTORNEY, JOINT COMMITTEE ON TAXATION

Mr. OOSTERHUIS. Thank you, Senator.

It is a pleasure for us to appear before you today and provide staff assistance to the committee in your consideration of these treaties. Our staff has prepared pamphlets on each of the treaties, which provide a section-by-section analysis of the treaty provisions. The introduction to each pamphlet highlights the more significant issues involved. We also have prepared a lengthy written statement which I will submit for the record. It analyzes in detail some of the more important tax policy issues involved in the treaty.

What I would like to do now is to discuss, informally if I may, a few of the more significant issues that have been mentioned earlier today and to present some of the arguments back and forth on the merits of these issues.

CREDIBILITY OF PETROLEUM REVENUE TAX

First, with respect to the petroleum revenue tax, I think it is fair to say that the statute establishes a fairly general standard of what might constitute a creditable income tax. The IRS now appears to be evolving toward an administrative position of defining what is a creditable income tax under that provision in a fairly narrow manner using, of course, U.S. income tax concepts.

In this context, the use of treaties to overcome technical difficulties in resolving differences between foreign tax systems and U.S. income tax concepts would seem to be an entirely appropriate tax policy mechanism. After all, our own income tax system is not a perfect or a pure income tax system. We do have a minimum tax, which has some features other than a strictly net income tax. The Treasury proposed 2 years ago, and the House adopted, a limitation on losses,

specifically with respect to the oil and gas industry, that has a somewhat similar impact to some of the features of the British PRT.

Given these variations which for internal reasons countries do apply to their domestic income tax systems, it would appear to be appropriate through the treaty process to be a bit more flexible in establishing the creditability of specific foreign taxes. The PRT is sufficiently close to matching U.S. concepts of an income tax that a good agreement can be made on this basis for making it creditable by treaty.

REFUND OF BRITISH CORPORATE TAX TO U.S. INVESTORS

Second, we would like to comment briefly on the refund of the British corporate tax to U.S. investors there. With respect to our direct investors, this is a major breakthrough for the United States in two respects. First of all, it does constitute a significant lowering of taxes for U.S. direct investors there. Second, and I think more importantly, it is indeed a precedent for the United States in future treaty negotiations and, in ongoing treaty negotiations with Canada, West Germany, France, and other countries. Having the British treaty contain this provision gives our country an advantage in those negotiations which we otherwise might not have.

I think, however, it is fair to say that, although it was a major breakthrough for our country to obtain the provision, it is also a provision that is in many respects in the British interest as well. Britain has traditionally been a country which welcomes U.S. investment. This provision, as included in the treaty and as interpreted by Treasury in its technical explanation, results in U.S. companies achieving the benefit, in most cases, of a lowering of British taxes and generally does not result in the U.S. Treasury receiving an increase in revenues through the lowering of British taxes causing a reduction in the foreign tax credits which in fact reduce U.S. tax.

Consequently, I think the treaty does provide a mechanism to encourage our companies to maintain and expand their operations in the United Kingdom, and that, under current British position, is certainly in their interest.

Second, we did make some concessions in this area. For example, we lowered our withholding rate on direct investment from 30 percent to 5 percent, so that our total effective tax rate on direct investment was lowered from 63 percent to 51.5 percent. Since the British total effective tax rate on direct investment was lowered from 52 percent to 42 percent, these were fairly comparable reductions by the two countries.

STATE TAXATION ISSUE

We would like to spend the remaining time, with respect to the British treaty, on the State taxation issue, which was described by Dr. Woodworth just previously.

I think there are fair arguments that substantial problems exist with the combined reporting system as it is in effect in some States today, particularly with respect to bringing foreign corporations into the combined group to which the unitary method is applied. I

think it can be argued that the major problem is the administrative burden and the recordkeeping burden that combined reporting imposes on taxpayers. If you have foreign corporations which operate in foreign countries, the records are in foreign languages, and they are kept in terms of foreign currencies and according to foreign accounting systems. Translating all those items to U.S. and any State's tax acounting standards can be quite a burden on the taxpayer.

Moreover, it is true that in many cases the amount of income apportioned to a State can vary quite substantially from that allocated under the U.S. Federal Government principles of arm's length transactions. From this, many observers argue that a distortion results in the amount of income that is subject to the State's tax. I think that is a fair argument in some cases.

However, as Dr. Woodworth did point out, the Federal Government, in applying its own arm's length transaction rule, has many problems, although those problems are related to specific transactions between related parties and are not related to the actual existence of related parties. So, it is a somewhat narrower area in which the problems occur.

Specifically, in 1973, the IRS conducted a study indicating that the general rule, which is to look at comparable independent transactions to determine the price or the profits arising from a transaction between related entities and to make an allocation between the two entities accordingly, cannot often be applied effectively because no comparable independent transactions exist. In the IRS 1973 study, in about 40 percent of the cases in which that issue arose on audit, there were no such independent transactions. Therefore, a more improvised rule had to be devised by the IRS agents conducting the audit and by the taxpayers involved.

So, there are significant problems under either system.

Nonetheless, the main point that can be argued is that the lack of uniformity in itself creates additional tax burdens on taxpayers which may not, in some cases, be necessary. Therefore, some Federal Government action may well be appropriate. However, it can be argued that there are a number of advantages in going the legislative route instead of the treaty route with respect to any resolution of this matter.

First of all, the existence of treaty provisions without legislation means that there will be a significant discrimination between companies. British-based multinationals doing business in the United States will have a different tax liability than U.S.-based multinationals doing business in Britain and foreign multinationals doing business in the United States. That discrimination is inherent in bilateral treaties.

Second, the treaty provision, in keeping with most treaty provisions, is written in fairly general terms in order to be flexibly interpreted by the countries involved. However, given the variety of rather complicated business situations in which these questions arise, these general rules will almost inevitably lead to interpretive problems.

Under treaties, the interpretive mechanism is, first, the mutual agreement procedures of the U.S. Government and the British Gov-

ernment, and barring that, State court decisions in disputes between taxpayers and the affected State government. These interpretive processes of either mutual agreement on the part of the Federal Government with the British Government, or of State court decisions, do not give much of an opportunity for the States to learn what are the precise rules which they must administer, and for taxpayers to determine exactly when they can and when they cannot be required to take into account some of the aspects of foreign corporations in determining the tax that is apportioned to a State in any particular case.

ISSUE OF STATE TAXATION

Finally, I think it is possible that the treaty provision could work to benefit taxpayers at the expense of the State government. Under traditional treaty principles, I am told, the provision could be interpreted not to apply in any case where the taxpayer wants to assert combined reporting as the correct method for allocating income. On the other hand, the treaty specifically limits a State from applying combined reporting to allocate income. If that is the interpretation, the result could be that a State would, in effect, be whipsawed; taxpayers could raise the issue when favorable to them, but the State could not. In the past, at least in many cases in California, taxpayers have raised the combined reporting argument themselves in certain circumstances when they thought it would be more favorable to them.

Senator JAVITS [presiding]. Couldn't the State help itself in that regard by its own legislation? In other words, a State by passing State law could prevent itself from being whipsawed; or, would we have to make some provision for that in Federal, either implementing law, or some understanding, et cetera, respecting the treaty?

Mr. OOSTERHUIS. There are ways the States could overcome the problem. However, a State would have to write legislation probably that would affect all taxpayers from all countries doing business within the State and not just specifically direct any legislation to British taxpayers, as the treaty provision does. Because most States have nondiscrimination or uniformity provisions in their State constitutions, the legislation would have to apply to all taxpayers, irrespective of whether or not the treaty provision applies.

Senator JAVITS. But we could not help them by Federal-implementing legislation or by any understanding respecting the treaty?

Mr. OOSTERHUIS. I think, perhaps, an understanding with respect to the treaty might help solve that problem, but I am not sure.

Senator JAVITS. If you would be good enough to consider that, we will consider it, too. I don't think, myself, that it would help. But I believe that their own legislation would help. But, as you say, that would have to be across the board.

POSSIBILITY OF STATES BEING WHIPSAWED

Isn't it a fact that the States can be whipsawed now, in other words, that a taxpayer can invoke his own method? On reconsideration, the taxpayers can't, because the State law applies to them, and we are going to relieve them of the State law.

Mr. OOSTERHUIS. That's right, Senator.

Senator JAVITS. That's exactly right.

I think that is a proper legal question for us to consider. I don't think we should allow the State to be whipsawed.

LEGISLATIVE ENACTMENT FOR PROBLEMS RECOMMENDED

Mr. OOSTERHUIS. These three matters, the interpretive problems in terms of working out specific rules that States could apply, the discrimination problem, and the problem of being whipsawed, all argue for a legislative enactment rather than enactment through the treaty process. This really is a very complicated area to deal with. In designing Federal legislation, the Ways and Means Committee and the Senate Finance Committee might well come up with rules that are more detailed than the rules in the treaty and that would balance the interests of the State and the interests of the foreign taxpayers in a fair manner. Any statutory provisions would thus probably vary somewhat from the terms of this particular treaty.

Senator JAVITS. But wouldn't our problem be that we could not, in that way, get anything out of the British Government, and we are getting something out of the British Government in this advance corporate tax situation?

Mr. OOSTERHUIS. Yes; if the assumption is that the British Government would not accept the treaty without this provision in it.

Senator JAVITS. You said legislative, not treaty action. That means no treaty at all. But we cannot accomplish the results which the treaty accomplishes because you can just legislate for the United States, you cannot legislate for the British. That is what this treaty does. It does bring us certain benefits.

Mr. OOSTERHUIS. Yes; it does in terms of any quid pro quo for this provision. The legislation would have the same benefits, though, that the treaty has, to British taxpayers operating in the United States.

Senator JAVITS. I know. But it would not have the same benefits to the American taxpayer.

Mr. OOSTERHUIS. That is a possibility; yes.

Senator JAVITS. Please go right ahead. I did not mean to interrupt you.

TASK FORCE RECOMMENDATION ON STATE TAXATION ISSUE

Mr. OOSTERHUIS. Last year a Ways and Means Committee task force considered the State taxation issue and recommended favorably to the full committee legislation which would limit the States' ability to combine report with foreign corporations. The chairman of the Ways and Means Committee has indicated that the task force recommendation will be taken up with other tax reform proposals later in this Congress, so that there will be a full debate and a thorough examination of the issue by at least that committee of Congress in the near future. That fact may well be of some value in discussing with the British this treaty without this provision, particularly if that legislation progresses through the Congress.

Senator JAVITS. Have you completed your statement in brief, now, or is there more that you wish to add. I, too, have to go to vote.

Mr. OOSTERHUIS. We have one comment that would be relevant on the Philippine treaty, but we can wait until you return.

Senator JAVITS. Thank you.

The Chair will declare a brief recess, and the committee will reconvene, I am sure, within the next 5 minutes, as soon as the chairman returns.

[A brief recess was taken.]

Senator CHURCH [presiding]. The committee will please come back to order. We are going to have problems, I am afraid. There are going to be more votes, in seriatim.

I am wondering if you could conclude your testimony as quickly as possible, Mr. Oosterhuis.

Mr. OOSTERHUIS. Yes. Mr. Chairman.

We have one brief point which is probably worth mentioning with respect to the Philippine treaty, and I would like Dave Brockway of our staff to discuss that with you briefly.

ADVANTAGES OF GOING TREATY ROUTE

Senator CHURCH. When I left to vote, you were making the point that you thought the question of what uniform system we should use to tax the earnings of foreign-owned subsidiaries in the United States should be handled not by way of treaty bilaterally, but by way of general legislation. Was that the point you were making?

Mr. OOSTERHUIS. I was saying that there appear to be several advantages in going that route.

Senator CHURCH. Thank you.

TREATMENT OF AIRLINES UNDER PHILIPPINE TREATY

Mr. BROCKWAY. We do not feel that the Korean treaty contains any provisions of any particular controversy. In the Philippine treaty, the major item of controversy is the treatment of airlines. This is the first treaty that does not contain a reciprocal exemption for shipping and air transport income. In the case of airlines, there is no restriction whatsoever on the power of either country to tax airlines. Apparently, as originally drafted, the treaty contained a limitation similar to the limitation contained in the case of shipping, but the airlines requested that it be deleted from the treaty because it was their position that the treaty should have nothing in it at all unless it provides for a reciprocal exemption. I understand that their position is that the treaty should be rejected, as a whole, in order to demonstrate clearly that it is U.S. treaty policy not to enter into tax treaties that do not reciprocally exempt airlines.

Senator CHURCH. Whose position is it that the treaty should be rejected as a whole?

Mr. BROCKWAY. That is what the Air Transport Association has told us is their position on this—the U.S. airlines. I gather they will be testifying a bit later today.

Senator CHURCH. I see.

Mr. BROCKWAY. There are two issues in the treaty relating to the taxation of airlines. The second one is that apparently the Philip-

pines engages in discrimination in the taxation of U.S. airlines and their own airlines. There is some dispute as to the extent of this discrimination. The nondiscrimination provisions of the treaty do not apply here.

I gather that the airlines are not interested in including a nondiscrimination provision with respect to air transport income. Their objective is to reject the treaty on the grounds that there should be no treaty without a reciprocal exemption. It should be noted that the Philippines is a developing country. It has some interest in taxing air transport income from sources within the Philippines, and it is not clear that the entire treaty should be rejected solely because there is some tax on air transport income.

If the committee decides that it does not want such a limitation in other treaties, but considers that this treaty is sufficiently important that it does not want to reject it, one possible alternative is to include in the committee report a statement that it does not consider this treaty in this regard to be a precedent for future treaties and to instruct the Treasury not to enter into treaties without a reciprocal exemption in the future.

Senator CHURCH. Well, no matter how often we say that a given provision is not to be treated as a precedent, it has a way of cropping up as one anyhow.

Mr. BROCKWAY. I think that is generally the case. However, there are few countries that will find it in their interest as part of their treaty policy not to include a reciprocal exemption for air transport income, particularly the developed countries. There may be some developing countries that will want to tax this income, but we have few treaties with those countries, and unless the overall treaty is beneficial to us, there is no overriding need, perhaps, to enter into treaties that do not provide such an exemption in the future.

Senator CHURCH. I think we should have some special testimony on this from administration witnesses. We have two treaties now that are being voted on, and the vote is underway.

I would ask the staff to see to it that tomorrow we do get some testimony on this particular point from the Government's side so we will have some explanation as to why airline income was exempt. I take it that the nondiscriminatory provision also is inapplicable to the airline industry.

Mr. BROCKWAY. That is correct.

In fact, it was in the treaty as originally negotiated, also. The airlines' understanding is that Philippine law would have discriminated against U.S. airlines, even under the original treaty provision.

Senator CHURCH. All right, thank you very much for your testimony.

[Mr. Oosterhuis' and Mr. Brockway's prepared statement follows:]

PREPARED STATEMENT OF PAUL OOSTERHUIS, LEGISLATIVE COUNSEL, AND DAVID BROCKWAY, LEGISLATION ATTORNEY, STAFF OF THE JOINT COMMITTEE ON TAXATION

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

light the provisions of the proposed treaties which present significant policy issues.

We would like to focus our discussion today on the relatively important tax policy issues presented by various provisions in these treaties. In a few cases the Committee may want to consider the option of reservation on a partcular provision of a treaty. However, it is likely that in most cases the provisions are not sufficiently troublesome or controversial that a recommendation of reservation on any particular treaty provision need be seriously considered. Instead in a number of instances the committee may want to consider stating in its recommendations of ratification that the policy reflected in a particular provision not be viewed as a precedent for future U.S. tax treaty positions. Indeed, in many of these areas the Committee may want to recommend that, subsequent to ratification of these treaties, the policies embodied in certain privisions be re-examined thoroughly by the Treasury Department, both in the context of legislative changes and the U.S. treaty negotiating position.

PROPOSED TREATY WITH THE UNITED KINGDOM

The treaty with the United Kingdom is the most important of the treaties and contains the most significant departures from prior U.S. treaties. We would like to discuss five of these matters.

Petroleum Revenue Tax.—The treaty treats the British Petroleum Revenue Tax (PRT) as a creditable income tax for U.S. foreign tax credit purposes. The PRT is a separate U.K. tax levied on profits from oil and gas extraction within the United Kingdom, including that part of the North Sea for which the United Kingdom controls drilling rights. In computing the tax, royalties and operating expenses from extraction operations are allowed as a deduction; no deductions are allowed for nonextraction related expenses. Interest costs are not deductible, but capital costs can be increased automatically by 75 percent (called an "uplift"). The PRT amount as so computed is separate from the normal U.K. income tax but is allowed as a deduction for U.K. income tax purposes.

Whether the PRT as so structured would be treated as a creditable tax in the absence of a treaty is not certain. The tax does meet most, but not all, of the characteristics which the Internal Revenue Service has stated will generally result in a tax being determined to be creditable. In any case, the treaty resolves this potential issue by applying its provisions to the Petroleum Revenue Tax (under Article 1) and by specifically making that tax creditable against U.S. income tax (Article 23, paragraph 1).

Some might question the policy of determining an income tax to be creditable before the Internal Revenue Service has had an opportunity to rule formally on the issue. Further, it could be argued that these determinations should be solely a matter of tax policy and thus should only be determined by the Internal Revenue Service through its normal administrative processes. In this particular case, however, it can also be argued that the economic substance of the tax is sufficiently comparable to U.S. notions of what constitutes an income tax that it does not require a major departure from applicable tax policy principles to treat the PRT as a creditable tax. Thus, the treaty in this case can be viewed as merely overcoming technical deficiencies in the structure of the U.K. tax.

Shipping Income.—A second area of significance in the U.K. treaty is the treatment of shipping income. The treaty provides (under Article 8) that income of ships or aircraft in international traffic operated by residents of one country is to be exempt from tax in the other country. By itself, this provision does not represent a major departure from past treaties, although it does not require, as many prior U.S. tax treaties do, that a ship be registered in the country of the operator's residence to qualify for the treaty exemption. But the exemption does represent a step away from the conclusions which some have reached in recent re-examinations of U.S. tax policy toward international shipping.

International shipping generally pays no tax anywhere in the world. Most countries exempt ships traveling into and out of their ports from their income taxes because most of the income-producing transportation activity takes place beyond their borders. In addition, owners and operators of these ships generally incorporate their operations (and register their ships) in countries

which do not tax shipping income; Liberia and Panama are good examples of countries in which many ships are based in part because those countries provide tax exemptions. Thus, in these cases the operators of ships in international traffic generally pay no tax either in the countries to and from which they travel or in their country of incorporation and registry.

In recent years there has been significant interest in changing the U.S. tax laws, and the U.S. negotiating position in tax treaties, to tax shipping into and out of the United States at least in some cases. Those arguing for this change believe it can be a first step toward initiating international arrangements (through bilateral treaties and perhaps multilateral agreements) whereby all international shipping income would generally be taxed in some jurisdiction. Moreover, some advocates view these changes as an effort toward minimizing the competitive advantages of operators locating their shipping operations in countries which do not tax shipping income. Among the advocates of legislative changes in this area has been a Task Force of the House Ways and Means Committee. It is likely that the full committee will seriously consider statutory changes in this area when it takes up the Administration's tax reform proposals later in this Congress.

The United Kingdom has been regarded as one country which does not effectively tax the shipping income of its residents (including U.K. corporations owned by U.S. interests) even in cases where these ships are not engaged in the international commerce of the United Kingdom. As we understand, this result occurs because generous depreciation provisions effectively eliminate any tax liability of these taxpayers. As a result, some U.S. companies (and other non-U.K. companies) have tended to establish U.K. corporations to conduct world wide shipping operations. They thus avoid any tax liability in any country in the world. The treaty provision, in effect, validates this method of operation

If the United States were to change its past policy toward international shipping, it can be argued that the exemption in the proposed treaty should be modified. Such a modification could prevent any shipping exemption from being used by any ultimate ship owner who in fact resides outside of the country of incorporation of the ship's operations. However, not enough study has yet been conducted, and not enough debate has taken place, to determine specifically how any new U.S. policy toward international shipping should be formulated.

Consequently, the process of ratification of this treaty is probably not the appropriate time to take any specific action toward establishing a new U.S. policy toward international shipping. However, it may also be appropriate that this treaty not be viewed as a precedent for future U.S. treaty policy—particularly as that policy applied to countries which encourage the incorporation and registry of ships which neither operate in the international commerce of that country nor are owned ultimately by residents of that country.

Entertainers and Athletes.—A third significant new provision in the U.K. treaty relates to the treatment of professional entertainers and athletes who are residents of one country but who earn income from performances in the other country. Under the existing U.K. treaty the income from personal services of these individuals is not subject to tax in the country where performed unless the entertainer or athlete is present in that country for more than 183 days or unless the services are performed in behalf of a resident of a country other than the United Kingdom. However, the proposed treaty provides that the income earned by public entertainers and athletes are to be subject to tax in the country where performed in any case where the total amount of gross receipts derived by the performer (including expenses reimbursed to or paid on behalf of the performer) exceed $15,000 for the year.

Under this provision the United States will be able to tax U.K. entertainers deriving over $15,000 from their U.S. performances, regardless of the length of time they spend in the United States. The United Kingdom will apply a comparable rule to U.S. entertainers and athletes performing in that country. Needless to say the new provision will primarily apply to those popular concert and television performers who in recent years have obtained sums substantially in excess of $15,000 for a single or brief series of performances in either country. In these cases under the treaty the entire amount will be fully subject to tax under the normal rules of the country where performed. Of course, under the treaty a tax credit will be provided against the income tax which the country of the performer's residence might otherwise levy on that income.

While this provision departs from the 183-day rule generally provided for most types of personal services, it is closer to the provision in the OECD model treaty is the provision which extends the benefits to U.S. shareholders of the and is fully subject to tax in the source country in all cases. Because entertainers and athletes do often receive large amounts of income over relatively short periods of time, and because no substantial problems exist in determining the amount of that income earned in a country, it would seem appropriate to permit the country where the income is earned to tax that income in those cases where it is substantial.

Shareholder refunds of U.K. tax.—An extremely important innovation in this treaty is the provisions which extends the benefits to U.S. shareholders of the refunds allowed under the United Kingdom's system of integrating corporate and individual income taxes. In 1973, the United Kingdom introduced a new system of taxing income from corporations which partially combines or integrates the tax paid by the corporation on its earnings with any tax paid by the shareholder with respect to distributions from the corporation.

Under the U.K. system an "Advance Corporation Tax" or "ACT" is collected from a U.K. corporation on any distribution to its shareholders. The amount of the ACT paid equals 35/65 of the amount of the distribution. At the corporate level, ACT payments can be credited, within certain limits against the regular U.K. 52-percent corporate income tax (called "mainstream tax") which would otherwise be due at the end of that year by the corporation. If insufficient mainstream tax is paid in that year, the ACT amount can be carried back two years and carried forward indefinitely to be credited against mainstream tax otherwise payable in those years.

At the shareholder level, in the case of shareholders who are U.K. residents, the amount of the ACT payment is in effect treated as an amount withheld by the U.K. government for payment of the shareholder's income tax on the dividend. That is, the amount of the taxable dividend received by the U.K. shareholder is increased by the amount of the ACT payment, and the shareholder is allowed a credit against the U.K. tax which would otherwise be due on the total dividend income. A cash refund is made if the ACT payment exceeds the shareholder's total U.K. income tax liability.

However, under U.K. law this credit or refund of the ACT payment to the shareholder is not allowed where the shareholder is a nonresident. The treaty modifies this provision of U.K. law by providing that, in the case of U.S. corporations owning 10-percent or more of the U.K. corporation paying the dividend (i.e., direct investors in U.K. corporations), a refund of one-half of the ACT paid and allowed as a credit to U.K. shareholders is to be allowed; in the case of other U.S. shareholders of U.K. corporations (i.e., U.S. portfolio investors) the full amount of the ACT is to be refunded.

In addition, the treaty permits the U.K. to impose a withholding tax on dividends paid to U.S. shareholders, as increased by the amount of the ACT refunded to those shareholders. On distributions to U.S. direct investors the withholding rate is to be 5 percent of the combined cash dividend plus the refunded one-half of the ACT payment. In the case of U.S. portfolio investors, the withholding tax is to be 15 percent of the cash dividend plus the full ACT refund. The withholding taxes are not imposed generally under U.K. law but are imposed by the United Kingdom. in those cases where that country has by treaty granted foreign investors some or all of the benefits of the ACT refund. Besides the United States these countries include France, Switzerland, Finland, Denmark and Ireland.

The effect of the ACT refund provisions for U.S. shareholders is to reduce the maximum U.K. tax burden (including both the ACT and the mainstream tax) on distributions from 52 percent to 42 percent, in the case of U.S. direct investors; for U.S. portfolio investors the maximum effective U.K. tax burden on distributions is reduced from 52 percent to 37 percent.

The agreement of the United Kingdom to make ACT refunds to U.S. shareholders, particularly the partial ACT refund to direct investors, is a very important concession by the United Kingdom. While the refund to portfolio investors has been extended by the United Kingdom to residents of other countries in tax treaties negotiated after it adopted the new integration system, and is substantially the same as the refund provided to U.S. shareholders in the existing U.S. tax treaty with France, the partial refund to U.S. direct investors is unprecedented. The proposed treaty represents the first time that a country

with a tax system which integrates corporate and shareholder taxation has agreed to make refunds to direct investors. The refunds will significantly reduce the amount of U.K. tax paid by U.S. investors with respect to dividends from subsidiaries operating in the United Kingdom (and, in certain situations, it may increase the tax they pay to the United States). Moreover, the U.K. concession here is particularly important in connection with the current U.S. tax treaty negotiations with, among others, France, West Germany and Canada. In each of these cases the issue of whether or not to extend to U.S. direct and portfolio investors in those countries the benefits of the credit or refund (or other comparable adjustments) of corporate taxes which those countries provide for their own residents is a major treaty issue. The precedent of the U.K. treaty gives our negotiators a significantly stronger position in bargaining with those countries.

It should be noted, however, that although the refund provision was clearly a concession on the part of the British, it was, at least in part, a concession which was in their own interest to make. The United Kingdom has traditionally welcomed U.S. direct and portofolio investors and continues to encourage new investment by these U.S. residents. The refund provision constitutes a significant incentive for additional investment by existing and potential U.S. direct investors because it reduces their taxes paid to the United Kingdom. Moreover, under the treatment of the refund for U.S. tax credit purposes provided for in the treaty and as interpreted by our Treasury Department in its technical explanation, this reduction in U.K. tax will not in most cases significantly increase the amount of taxes which the U.S. investors pay to the United States on their dividends. From this point of view, the provisions dealing with the ACT refunds are in the interests of the United Kingdom as well as in the interest of U.S. investors.

Moreover, it should also be recognized that the United States made significant concessions to the United Kingdom in exchange for the agreement of the United Kingdom to make the ACT refunds. First, the United States on its part agreed to make comparable reductions in the 30-percent U.S. withholding tax on dividends paid by U.S. corporations to U.K. investors. U.S. withholding taxes are reduced to 5 percent on dividends to U.K. direct investors and 15 percent on dividends to U.K. portfolio investors. Thus, the effective U.S. tax rate on U.K. direct investors is reduced from 63 percent (48 percent corporate tax plus a 30 percent withholding tax on net dividends) to 51.5 percent, and the U.S. tax burden for U.K. portfolio investors is reduced from 63 percent to 55.5 percent.

Second, in the case of U.S. direct investors in U.K. corporations, the United States agreed in the treaty to treat ACT refunds and the unrefunded portion of the ACT for foreign tax credit purposes in a manner which is generally favorable to direct investors. In addition, the technical explanation of the treaty issued by the Treasury Department details the manner in which U.K. corporate taxes are to be treated in determining the amount of the indirect foreign tax credit which will be allowed to U.S. direct investors. It is our understanding that the basic treatment provided in the technical explanation was specifically part of the negotiated agreement with the United Kingdom. The result of the treatment provided in the treaty and the technical explanation is that the benefit of the ACT refund tends to accrue to the U.S. direct investors. Although it is not clear what the U.S. foreign tax credit treatment would be in the absence of the treaty, the agreement by the United States to apply the generally favorable tax credit rules is an important concession to the United Kingdom which will make U.S. direct investment in the United Kingdom more attractive.

In this connection, it should be observed that the technical explanation is the first more or less comprehensive public statement made by the Treasury Department (either with respect to a treaty or with respect to the proper interpretation of the Internal Revenue Code in the absence of a treaty) on the general question of how to treat foreign corporate taxes for purposes of our indirect foreign tax credit in cases where the amount of foreign corporate taxes paid varies with the amount of dividends distributed. The problems presented in this context are exceedingly complex and a thorough examination has not been conducted as to what the appropriate rules should be.

Consequently, the Committee may want to indicate that, in recommending ratification of the U.K. treaty, the Committee does not intend the treatment of U.S. taxes to be necessarily considered a precedent for future treaties. In fact,

from the point of view of our own staff a careful review by the Treasury Department in the near future of how corporate taxes under various partial integration schemes should be treated for indirect credit purposes under the Internal Revenue Code should be undertaken.

Limitation on State taxation—The most controversial provision of the treaty is Article 9, paragraph 4, which has the effect of limiting the methods which States of the United States may use in apportioning income for purposes of State income taxes. Under its terms, the treaty states that in determining the tax liability of an enterprise which is a resident of one country doing business within the other country, the national, State and local governments of the other country may not take into account the income, deductions, receipts, or outgoings of any related enterprises of the enterprise doing business in the other country if the related enterprises are resident of the first country or any third country. Since the national governments of the United States and the United Kingdom do not generally take into account items of related entities in any way affected by the treaty provision, and since the political subdivisions of the United Kingdom apparently do not impose income taxes, the intended application of this provision is to limit the use of certain apportionment methods by States of the United States.

In order to understand more fully the impact of this provision, the methods by which States determine income subject to corporate tax in any State should be discussed. Most major corporations have operations that extend beyond the borders of any one State. In determining how much of this income is subject to tax in any State, all States imposing an income tax use some form of apportionment system. Most States start with the total income of a single corporation and determine what activities of the corporation constitute a single (or "unitary") business regardless of where those activities takes place. In most cases all of the income of the corporation will be treated as attributable to one unitary business. However, if the corporation is in fact engaged in two or more such businesses, the State will attempt to separately account for the income and deductions of each business. Once the net income of the unitary business is determined, the income is apportioned among the taxing jurisdictions in which the business is conducted according to variations on a basic three-factor formula, under which the income from the unitary business is multiplied by the average ratio of sales, payroll, and property values of the business within the State to total sales, payroll and property values of the corporation associated with unitary business. This technique of apportionment is frequently called the "unitary method". It is used in some form by virtually every State which imposes a corporate income tax.

In applying the unitary method some States have adopted "combined reporting" requirements. These States apply their three-factor formula not only to the income of a corporation doing business within the State, but also to the income of related corporations (including subsidiaries, parent corporations and brother-sister corporations) where it is determined that the activities of the related corporations constitute a unitary business. For example, if a U.S. manufacturing company (operating in a State requiring combined reporting) owns a U.K. subsidiary which sells products manufactured by the U.S. parent, the income subject to tax in the combined reporting State would be determined by applying the average of the ratios of sales, payroll, and property values in the State to total sales, payroll, and propery values, respectively of *both* corporations in *both* countries; the average of these ratios would then be multiplied against the *combined* worldwide income of the two corporations.

It should be pointed out that the application of the combined reporting does not automatically "tax" the income of the related corporations whose income, sales, payroll and property values are taken into account. It only includes all of these items in the apportionment formula, and it may either decrease or increase the taxable income from sources within the State attributed to the corporation. Taking into account the income, sales, payroll, and property values of a related corporation in determining the income apportioned to a State will not increase the amount of income subject to tax in that State unless the income of the related corporation is on the average larger per unit of sales and per dollar of payroll and property values than the income of the other corporation. Viewed in this way combined reporting is essentially an attempt to define the amount of income properly attributable to each entity and for each

taxing jurisdiction. But because the method of attributing income differs from that used by the Federal Government (and by most foreign governments), the amount of income apportioned for a taxing jurisdiction in any one case can vary widely.

Combined reporting as described above has for a number of years been required in many instances in California and Oregon; Alaska has also required combined reporting in recent years. However, since the requirement of combined reporting is generally determined by State tax administrators (usually upon audit) and State courts, rather than by statute, it is not certain which other States may have occasionally in the past or will in the future require combined reporting in some circumstances.

The combined reporting requirements of these States apply to related foreign corporations, as well as to related U.S. corporations. This extension can in many circumstances present two problems. First, the related corporations of other countries must keep records which satisfy the reporting requirements; these records must then be available for examination by State officials upon audit. If a State determines what constitutes the definition of a unitary business broadly, these additional recordkeeping and reporting requirements can affect a number of corporations operating in a number of different countries. The burden of translating these records into a different currency, a different language and a different accounting system can be substantial. In fact, it appears that in California combined reporting has not been limited to vertically integrated operations of related foreign and domestic corporations where intercompany transactions are substantial; in some cases the State has required combined reporting even for so-called conglomerate corporations where the lines of business of the related corporations are separate except for common management. When applied this broadly, it can be argued that combined reporting results in a taxpayer recordkeeping burden which outweighs any advantage in accurately determining income.

A second problem with combined reporting when applied to related foreign corporations is that in some foreign jurisdictions payroll levels and property values are substantially lower than those in the United States. In certain of these jurisdictions (perhaps partly for those reasons) net income determined under arm's-length standards may be considerably higher relative to payroll levels and property values than is generally the case in the United States. But under the apportionment formula based on sales, payroll and property values, sufficiently small amounts of income will be apportioned to foreign jurisdictions that most observers would agree that some misallocation of income occurs. This situation is more likely to result, however, for related foreign corporations operating in less developed countries than for those whose operations are in developed industrial countries like the United Kingdom.

It should also be pointed out that the other methods of allocating income between foreign and domestic corporations, including methods of allocating income used for Federal tax purposes, also present many administrative problems in those cases where substantial intercompany transactions occur. The Internal Revenue Service regulations (under section 482 of the Internal Revenue Code) basically require that income be allocated between related entities on an arm's-length basis. Although the regulations specify a number of preferred allocation techniques (applicable to sales between related entities), each technique generally requires the availability of information regarding the prices used or profits received in comparable transactions between unrelated parties. However, frequently no closely comparable transaction exists. An IRS survey conducted in 1973 indicates that in over 40 percent of the audit cases where the pricing of sales between related parties was an issue, the specified methods of allocation involving unrelated transactions could not be applied. In these cases IRS agents and the courts have been left to determine the proper allocation on whatever ad hoc basis seems appropriate. Because of these difficulties in applying the Federal Government's rules, the area of income allocation results in many taxpayer-IRS disputes and time-consuming court cases.

Given the problems which exist with the States' methods of apportionment under combined reporting and with the Federal Government's allocation rules, there is considerable disagreement as to which method is preferable in various situations. But the existence of widely differing methods among the States and between the States and the Feedral Government in itself creates substantial

burdens for taxpayers. In such a situation it may be appropriate for the Federal Government to decide that establishing a single system of income allocation (or at least minimizing the variation of methods permitted) for both the Federal and State governments is appropriate.

However, any Federal action involves balancing the goal of minimizing any interference with the States' traditional authority over their own revenue collection with the desire to alleviate reporting burdens on taxpayers. Also, the action should not produce significant competitive disadvantages between companies doing business within any State or between States seeking to attract new business. Finally, any resolution must deal with a number of technical issues which arise in determining what apportionment techniques may be appropriate in a wide variety of business circumstances. In such a situation it can be argued that the appropriate avenue for Federal action is through legislation rather than through bilateral treaties.

Action through treaties, including the proposed treaty with the United Kingdom, creates the possibility of significant discrimination between companies doing business in one State. A U.K.-owned U.S. corporation operating in a combined reporting State is likely to have a significantly different State tax liability than a U.S.-owned corporation operating in that State which also has subsidiaries in the U.K.or a third country. Moreover, the proposed treaty provision (as interpreted in Treasury's Technical Explanation) applies to prevent taking into account related foreign corporations of a U.K.-owned U.S. corporation, but does not limit the taking into account of the foreign operations of a U.K. corporation which has a branch in the United States. This too can create a problem of discirmination between competing taxpayers in substantially the same circumstances.

This treaty provision, in keeping with most tax treaty provisions, is written in relatively general terms in order that it may be flexibly interpreted by the two countries. Interpretation of the treaty provision occurs first in the Treasury Department's technical explanation of the treaty. Further interpretation can take place through the Mutual Agreement Procedures of Article 25), under which the appropriate officials of the U.S. and U.K. governments may consult in order to reach agreement on matters in dispute. Finally, of course, the State courts (and perhaps the Federal courts) will interpret the treaty provision in cases involving disputes between any State and an affected taxpayer.

Since the treaty provision is stated in general terms, interpretative questions are likely to arise. For example, disputes may arise because under the treaty States may be allowed to use some form of apportionment in order to determine an arm's-length allocation in cases of transactions between related corporations. What, if any, limitation the provisions establishes in these cases is not clear. However, the established procedures for resolving such disputes do not provide for any formal involvement of the State governments whose rules and revenues are at stake. Moreover, where no interpretation under the mutual agreement procedures has been set forth, the States and taxpayers can only determine the precise rules which they will be permitted to use through court decisions.

Thus, the treaty, drafted in the usual manner, does not contain the type of detailed technical rules which can refine a policy to meet the variety of situations faced by corporations and the States in which they operate and can balance the interests of the States with the burdens created on taxpayers. Finally, the provision proposed here, like any treaty provision, has not been subjected to the process of public hearings, comment and debate which can assist in the formulation of precise and balanced rules to deal with a complex problem.

These points tend to argue for a legislative approach to any action which the Federal Government may deem appropriate. The accomplishment of such legislation is a realistic possibility. Earlier this year a Task Force of the Ways and Means Committee recommended to the full Committee that substantial limits be placed on the States' authority to require combined reporting with related foreign corporations. The full Committee will include the Task Force's recommendations in its agenda when it considers tax reform legislation later in this Congress.

The Committee may thus desire to recommend to the Senate that the treaty be ratified with a reservation on this issue. However, if the Committee decides that the treaty provision should be accepted, perhaps some additional language

interpreting the treaty provision regarding more technical matters would be helpful. Such language could, perhaps, be included in the Committee's report to the Senate.

PROPOSED TREATIES WITH ISRAEL AND EGYPT

Although the hearings on the proposed treaties with Israel and Egypt have been postponed at the request of the Treasury Department, the staff has prepared pamphlets describing these treaties as they presently exist. The delay in considering these treaties gives the Treasury Department the opportunity to reexamine some of the more controversial provisions which are contained in those treaties. Specifically, the treatment of the proposed Israeli investment incentive grant program and the treatment of compulsory loans to the Israeli Government raise significant policy issues (as well as technical problems). In addition, the provisions in the proposed Egyptian Treaty establishing nonreciprocity with respect to the dividend withholding rates of the two countries and, in effect, validating the Egyptian tax holiday incentives raise both technical and policy questions.

PROPOSED TREATY WITH THE REPUBLIC OF THE PHILIPPINES

The proposed treaty with the Philippines contains few provisions of any controversy. The treaty is generally similar in form to recent U.S. income tax treaties and to the OECD model tax treaty.

There are three matters contained in the treaty which we would like to discuss.

Shipping and air transport income.—The first is the provision dealing with the taxation of shipping and air transport profits. This is the first U.S. tax treaty which does not provide for the reciprocal exemption of shipping and air transport profits. In the case of air transport profits, the treaty contains no restriction whatsoever on either country's right to tax income from sources within that country which is earned by residents of the other country. In the case of shipping profits, the treaty limits the tax which may be imposed by either country to 1.5 percent of gross revenues derived from that country (this tax rate limitation on both countries is to be reduced in the event that the Philippines concludes a tax treaty with a third country under wsich a lower tax rate limitation is established).

The Philippines refused to accept the usual provision contained in U.S. tax treaties under which both countries would have agreed to exempt shipping and air transportation income earned by residents of the other. The Philippines took this position because it is one of the few countries of the world which imposes a significant tax on foreign shippers and aircraft operators doing business in its commerce and it wished to preserve most of its right to maintain those taxes. Since the United States, nowithstanding the treaty, will impose virtually no tax under the Internal Revenue Code on shipping and air transport income earned by Philippine residents operating in U.S. commerce, the actual tax rates imposed by the two countries under the treaty will not be reciprocal.

The airline industry argues that the United States should not depart from prior treaty policy and accept a provision which permits the other country to tax shipping and aircraft operating income. The tax paid in the Philippines either reduces U.S. tax revenues (to the extent the Philippine tax can be credited by a particular taxpayer against U.S. income tax) or represents an increased cost to U.S. companies doing business in the Philippines (to the extent the U.S. companies have no U.S. tax liability or have excess foreign tax credits without regard to the Philippine tax). In addition, it is probably correct that other developing countries would rely on this provision as a precedent in attempting to negotiate tax treaties with the United States which do not provide the reciprocal exemption to shipping and air transport income. Nonetheless, at least with respect to shipping income, there has been increasing interest in recent years in moving away from a system of exemptions (as is discussed in more detail above in connection with the U.K. treaty) and the Philipine treaty is consistent with that position.

Perhaps more important than the fact that the treaty does not provide for the complete exemption of shipping and air transport income is that the treaty permits discrimination in the Philippine tax treatment of U.S. companies and

their Philippine competitors. The potential for discrimination is different in the case of shippers and airlines.

First, while the Philippines imposes on U.S. airlines a tax equal to 2.5 percent of their gross revenues from Philippine sources plus a corporate franchise tax of 2 percent of the same amount, the Philippine Airlines (PAL) is exempt from that 2.5 percent tax but instead pays a tax of 2 percent on its worldwide gross revenues. There is some dispute as to the actual difference in the Philippine tax burden imposed on income derived by PAL and that imposed on the U.S. airlines on their income from operating into and out of the Philippines. The U.S. airlines take the position that they are subject to a 4.5 percent tax while PAL is only subject to a 2 percent tax. The U.S. Treasury, however, takes the position that the effective tax burden on PAL is about 4 percent (compared to the 4.5 percent burden of U.S. airlines) because the tax on PAL is computed on a broader base. In any event, it appears that there may be at least some discrimination, and it is specifically permitted to continue under the treaty.

A separate type of discrimination occurs with respect to U.S. shipping companies and their Philippine competitors. Under Philippine law, Philippine shipping corporations receive recurring 10-year exemptions from tax; thus, they in effect pay no Philippine tax. U.S. shippers, however, do not receive the exemptions and would be paying Philippine tax at the treaty rate of 1.5 percent of gross revenues (reduced from the statutory 2.5 percent rate). The proposed treaty also permits this discrimination to continue, although the treaty does reduce the discrimination which otherwise would exist.

It should be noted that the treaty leaves open the option for the U.S. Government to retaliate against this discrimination by increasing the U.S. income tax on Philippine corporations under the antidiscrimination provisions of the Internal Revenue Code (sec. 896). However, given the limited contracts which Philippine aircraft operators and shippers probably have with the United States, it is doubtful that this retaliation would have much impact.

If the committee decides that the failure to provide for the exemption of shipping and air transport income presents sufficiently troublesome problems, it could recommend that the treaty be rejected. However, rejection of the treaty will not by itself end the taxation by the Philippines of U.S. shippers or airlines.

If the committee decides that the potential for discrimination by the Philippines against U.S. shippers and airlines is sufficiently troublesome, it could recommend the adoption of the treaty subject to a reservation on the Shipping and Air Transport provision (Article 9) to the extent it permits this discrimination. It must be emphasized, however, that the Philippines may refuse to ratify the treaty subject to such a reservation.

Alternatively, if the committee does not want to take either of the above actions because it feels that the treaty is sufficiently important that it should be ratified notwithstanding any problems presented by the shipping and air transport provisions, the committee may wish to include a statement in its recommendations emphasizing its concern and strongly urging the Treasury not to accept similar provisions in future treaties.

Public entertainers and athletes.—The proposed Philippine treaty, like the proposed treaty with the United Kingdom, contains a separate rule covering the taxation of public entertainers and athletes which are different than those applicable to the taxation of personal services generally. Income received by an employee resident in one country is not taxable by the other country unless the individual remains there for at least 90 days during the taxable year, and income from personal services performed in an inadependent capacity by a resident of one country is not taxable by the other unless the gross income of the nonresident from that other country for the year exceeds $10,000. In the case of public entertainers and athletes, however, the exemption applies only if their gross income from performing services in the other country not exceed the lesser of $100 a day or $3,000 a year.

The issues raised by this provision are substantially the same as those raised by the public entertainers provision in the U.K. treaty. Consequently, in the event that the Committee decides to take any action on the public entertainers provision in the U.K. treaty, similar action would probably be appropriate here.

Royalty income.—The withholding tax rates established under the treaty with respect to royalties are not strictly reciprocal. The limitation of the withhold-

ing tax imposed by the United States is 15 percent of the gross amount of the royalty. The withholding tax on royalties imposed by the Philippines may not exceed 25 percent except that royalties paid by a corporation registered with the Philippine Board of Investments and engaging in preferred areas of activity are limited to 15 percent. However, these Philippine withholding rates are to be reduced in any case where the Philippines reduces its rates to a lower level in a treaty with a third country.

Reciprocity in withholding rates is one of the basic policies of U.S. treaty negotiation. However, in this case, given the variable withholding rates established for the Philippines and the probablity that a substantial part of U.S. corporate investments in the Philippines will be subject to the lower 15 percent rate, this provision would seem to raise no serious problems.

PROPOSED TREATY WITH THE REPUBLIC OF SOUTH KOREA

The proposed treaty is in virtually every respect similar to recent U.S. income tax treaties and to the model income tax treaty of the Organization for Economic Cooperation and Development (OECD). It contains no major provisions which warrant special attention of the Committee.

However, the treaty shipping provision (Article 10), which exempts income from shipping in international traffic from tax in one country when earned by a resident of the other country, does not require that the ships of the resident also be registered in that country. As discussed earlier in connection with the U.K. treaty, this represents an expansion of the exemption provision over most prior U.S. treaties.

In an exchange of notes signed at the time the treaty was signed, the United States offered assurances that, when circumstances permit, the United States would be willing to resume discussions regarding the interference of the United States tax system with the operation of tax incentives offered by the Government of Korea. Validation of these types of incentives in tax treaties have in the past produced substantial controversy. However, since no substantive agreements were reached, no such controversy is before the Committee at this time.

Senator CHURCH. Would our next witness like to come up to the witness table, settle in and get comfortable, please? We now welcome Mr. Norman J. Philion, the executive vice president of the Air Transport Association of America.

I am sorry, but I will have to go to vote. I will get back as quickly as I can.

Please excuse me for a few minutes.

[A brief recess was taken.]

Senator CHURCH. The committee will please come to order.

Mr. Philion, you do understand our time problems and the voting interruptions, so anything you can do to abbreviate your testimony and submit your written statement would be appreciated.

STATEMENT OF NORMAN J. PHILION, EXECUTIVE VICE PRESIDENT, AIR TRANSPORT ASSOCIATION OF AMERICA, ACCOMPANIED BY MR. JOHN KRIMSKY, JR., VICE PRESIDENT, PAN AMERICAN WORLD AIRWAYS, WASHINGTON, D.C., AND JAMES T. O'HARA, SPECIAL COUNSEL TO THE AIR TRANSPORT ASSOCIATION OF AMERICA, JONES, DAY, REAVIS AND POGUE, WASHINGTON, D.C.

Mr. PHILION. Thank you, Mr. Chairman. We appreciate this opportunity to present the views of the airline industry on the proposed U.S.-Philippine tax treaty.

I am accompanied this morning by John Krimsky, who is vice president, Federal Affairs, Pan American World Airways, and who is here as chairman of an airline industry committee on the Philippine tax treaty, and by our special counsel, James O'Hara.

CONCERNS ABOUT PHILIPPINE TAX TREATY

Our concerns about and views on the proposed U.S.-Philippine tax treaty were made known to the Departments of State and Treasury during the 1976 negotiations. Our concern was then, and remains now, that the proposed treaty: Does not include the reciprocal exemption, contained in every other U.S. tax treaty, which precludes the double taxation of international airlines; permits highly discriminatory Philippine taxation of U.S. international arlines; and finally, it creates a far-reaching precedent for application to other U.S. tax treaties, thereby encouraging significantly increased and discriminatory foreign taxation of U.S. international airlines.

Apparently, Mr. Chairman, the Treasury Department views this as a concern of only one airline. I want to make the record clear that I appear before you this morning in behalf of not only all U.S. airlines serving the Philippines, but all other U.S. international airline members of the Air Transport Association, who, of course, provide extensive service throughout the world and are concerned about the precedential effect of this treaty.

We, therefore, strongly urge the committee, reluctantly—we do not enjoy appearing before you to address a treaty in this fashion—to withhold ratification of the proposed treaty, pending further review and appropriate revision of article 9(2). Unless otherwise warranted by significant foreign policy considerations requiring subordination of existing U.S. law, subordination of longstanding treaty policy, and subordination of broad aviation policy reflecting the national interest in U.S. international air commerce, such a revision of article 9(2) should incorporate the standard reciprocal exemption for international airline operations.

That standard exemption appears in every single U.S. treaty in existence, including the treaties with the governments of the United Kingdom and South Korea, which you are considering today, as well as other pending treaties.

Under the reciprocal exemption, profits from the operation of aircraft in international commerce are taxed only in the country in which aircraft are registered, and not in any other country.

Under the pending U.S.-U.K. treaty, for example, the income of U.S. airline operations attributable to U.K. sources would not be taxed in the United Kingdom. That income would be taxed in the United States where, because of applicable Federal law, aircraft of U.S. airlines must be registered. Conversely, of course, the income of British airlines attributable to U.S. sources would be taxed in the United Kingdom and not in the United States.

The first U.S. tax treaty containing the reciprocal exemption was executed in 1940. Thus, for the last 37 years, it was the unbroken policy of our Government to negotiate and ratify treaties containing reciprocal exemptions for airline profits. We are unaware of any shift in U.S. foreign policy justifying a departure from this policy.

As a matter of fact, the position of this administration on the reciprocal exemption was reaffirmed when the Treasury Department released its model tax treaty just this past May, on May 17. Article 8(1) of the model retains the reciprocal exemption by providing, and I quote:

> Profits of an enterprise of a Contracting State from the operation in international traffic of ships or aircraft shall be taxable only in that state.

Unfortunately, article 9(2) of the pending Philippine treaty is directly contrary to the Treasury model.

PHILIPPINE TREATY'S EFFECT

The intent of the U.S.-Philippine tax treaty language, as we understand it, is to allow the Philippine Government to tax U.S. airline revenue attributable to Philippine sources at any rate and under any method it decides to impose. We understand that the Treasury Department recognizes that the Philippine Government intends, under article 9(2) to maintain its present system of taxing U.S. airlines on their gross Philippine billings, as provided in section 24(b)(2) of the Philippine National Internal Revenue Code.

Under present nontreaty circumstances, U.S. airlines are taxed at the rate of 2.5 percent of gross billings attributable to operations in the Philippines, while Philippine airlines are subject only to U.S. taxes on their taxable income—that is, net income from U.S. sources. This discriminatory practice, which developed in the absence of a treaty with the Philippine Government, would be sanctioned by the United States if the proposed treaty is ratified.

Additionally, under the proposed Philippine treaty, U.S. airlines would be paying taxes to the Philippine Government that would otherwise be paid to the United States. Under all other U.S. tax treaties, there are no foreign taxes paid, and U.S. tax revenues received by the Treasury Department are increased accordingly.

Finally, I should point out, Mr. Chairman, that adoption of the proposed treaty would be in conflict with the International Air Transportation Fair Competitive Practices Act of 1974. Congress enacted that legislation in order to bring to an end a variety of unfair and discriminatory competitive practices, including discriminatory tax practices, against U.S. international airlines by foreign countries. Foreign countries will have reason to question the intention of the U.S. Government concerning these discriminatory practices if this treaty is ratified. Such policy inconsistency should be disavowed.

During the negotiation of the proposed treaty last year, the Treasury Department indicated to us that the Philippine negotiating team was firm on the elimination of the reciprocal exemption, but would agree to reduce the gross billing rate from 2.5 percent to 1.5 percent.

Our response to this offer was that reference to any rate would be an unacceptable departure from the established reciprocal exemption policy.

In this connection, it should be noted that article 9(1) of the treaty provides for a tax on gross revenues from shipping at a rate not in

excess of 1.5 percent. We are not aware of any opposition to that position by the shipping industry. However, the recently released report of the House Ways and Means Committee's Task Force on Foreign Source Income calls attention to a tax avoidance problem within the shipping industry not present in the airline industry. The problem cited is the potential for U.S.-owned or U.S.-operated ships to be held in a foreign corporation, the income of which would not be subject to U.S. taxes.

Since all aircraft of a U.S. international airline must be registered within the United States, there is no comparable potential for the avoidance of U.S. taxes as there may be in the shipping industry; as a matter of fact, the task force strongly recommended that Treasury renegotiate for shipping without affecting air transportation.

PRECEDENTIAL IMPACT OF RATIFICATION

If the committee ratifies this treaty in its present form, the precedential impact of such actions on U.S. airlines cannot be avoided by committee report assurances indicating this is an isolated or special case not to be regarded as a new policy. As you pointed out yourself, Mr. Chairman, such disclaimers would have little effect upon the positions of other countries. They would look to what was done, not to what was said. If the bottom line is the departure from the consistent policy of the United States, and if that departure is made over the opposition of U.S. airlines, it would be understandable for other countries to regard it as a precedent which they would be entitled to adopt, despite whatever self-serving contrary statements appeared in the record.

It is not possible, Mr. Chairman, to estimate the potential effect of this precedent because once it was established, other countries, both developing and developed, could advocate similar treatment with even broader exposure. Therefore, incorporation of the reciprocal exemption by the committee would avoid substantial cost to U.S. airlines and revenue loss to the U.S. Treasury.

WITHHOLDING RATIFICATION URGED

We respectfully urge, Mr. Chairman, that the ratification of this treaty be withheld, and that the Treasury be instructed to review article 9(2) with a view to incorporating the standard reciprocal exemption.

Thank you very much.

[Mr. Philion's prepared statement follows:]

PREPARED STATEMENT OF NORMAN J. PHILION, AIR TRANSPORT ASSOCIATION OF AMERICA

My name is Norman J. Philion. I am Executive Vice President of the Air Transport Association of America, which represents virtually all of the scheduled airlines of the United States. I am accompanied by John Krimsky, Vice President—Federal Affairs, Pan American World Airways, Inc., who is Chairman of an airline in dustry committee on the Philippine Tax Treaty, and by our special counsel, James O'Hara, of the firm of Jones, Day, Reavis & Pogue.

We appreciate the opportunity to present the views of the airline industry on the proposed U.S.-Philippine tax treaty. These views were made known to

the Departments of State and Treasury during the 1976 negotiations. Our concern was and is that the proposed treaty:

Does not include the reciprocal exemption, contained in every other U.S. tax treaty, which precludes the double taxation of international airlines;

Permits highly discriminatory Philippine taxation of U.S. international airlines; and

Creates a far-reaching precendent for application to other U.S. tax treaties, thereby encouraging significantly increased and discriminatory foreign taxation of U.S. international airlines.

The scheduled airlines of the United States, therefore, strongly urge the Committee to withhold ratification of the proposed U.S.-Philippine tax treaty pending further review and appropriate revision of Article 9(2). Unless otherwise warranted by significant foreign policy considerations requiring subordination of existing U.S. law, long-standing treaty policy, and broad aviation policy reflecting the national interest in U.S. international air commerce, such a revision of Article 9(2) should incorporate the standard reciprocal exemption for international airline operations.

THE STANDARD RECIPROCAL EXEMPTION

The opposition of the airlines is based upon the unprecedented absence in this treaty of the traditional reciprocal exemption precluding the double taxation of international airlines. Under the reciprocal exemption which appears in every single United States treaty in existence—including the treaties with the Governments of the United Kingdom, Israel, Egypt, and South Korea, which you are presently considering—profits from the operation of aircraft in international commerce are taxed only in the country in which such aircraft are registered and not in any other treaty country.

Under the pending U.S.-United Kingdom treaty, for example, the income of U.S. airline operations attributable to United Kingdom sources would not be taxed in the United Kingdom. That income would be taxed in the United States where, because of applicable Federal law, aircraft of the U.S. airlines must be registered. Conversely, of course, the income of British airlines, for example, attributable to United States sources, would be taxed in the United Kingdom and not in the United States.

Apart from United States treaty policy, this reciprocal exemption has been adopted by the Organization for Economic Cooperation and Development (O.E.C.D.) in its 1963 model Draft Double Taxation Convention. This model was adopted for the very reason that it avoids the double taxation to which airlines are particularly exposed by the very nature of their business. The O.E.C.D. model is the starting point for most treaty negotiations worldwide and, as a member, the United States has consistently followed the O.E.C.D. approach.

Similarly, the Council of the International Civil Aviation Organization (ICAO), a United Nations organization, adopted, with the U.S. support, a resolution requesting each Contracting State to grant a reciprocal exemption to the income of air transport enterprises. Both the U.S. and the Philippines are Contracting States of ICAO.

The first U.S. tax treaty containing the reciprocal exemption was executed in 1940. Thus, for the last 37 years it has been the unbroken policy of our government to negotiate and ratify treaties containing reciprocal exemptions for airline profits. We are unaware of any shift in United States foreign policy justifying a departure from this policy.

As a matter of fact, the position of this Administration on the reciprocal exemption was reaffirmed when the Treasury Department released its "model" tax treaty on May 17, 1977. Article 8(1) of the model retains the reciprocal exemption by providing:

"Profits of an enterprise of a Contracting State from the operation in international traffic of ships or aircraft shall be taxable only in that State."

Article 9(2) of the pending Philippine Treaty is directly contrary to the Treasury model. It states:

"Nothing in the Convention shall affect the right of a Contracting State to tax, in accordance with domestic laws, profits derived by a resident of the other Contracting State from sources within the first-mentioned Contracting State from the operation of aircraft in international traffic."

The intent of the U.S.-Philippine tax treaty language, as we understand it, is to allow the Philippine government to tax U.S. airline revenue attributable to Philippine sources at any rate and under any method it decides to impose. It could be argued that the term "profits" could be interpreted to mean "net income". However, we understand the Treasury Department recognizes that the Philippine government intends, under Article 9(2), to maintain its present system of taxing U.S. airlines on their "gross Philippine billings" as provided in section 24(b)(2) of the Philippine National Internal Revenue Code.

In our judgment, acquiescence to the Philippine position by the U.S. negotiators was inappropriate, and should not be sanctioned by ratification of the proposed treaty in complete disregard for the traditional reciprocal exemption.

DISCRIMINATORY EFFECTS OF THE PROPOSED TREATY

Under present non-treaty circumstances, U.S. airlines are taxed at the rate of 2½ percent of "gross billings" attributable to operations in the Philippines, while Philippine airlines are subject only to U.S. taxes on their "taxable income"—that is, net income from United States sources. This discriminatory practice, which developed in the absence of a treaty with the Philippine government, would be sanctioned by the United States if the proposed treaty is ratified.

Additionally, under the proposed Philippine treaty, U.S. airlines would be paying taxes to the Philippine government that would otherwise be paid to the United States. Under all other U.S. tax treaties, there are no foreign taxes paid, and U.S. tax revenues received by the Treasury Department are increased accordingly.

Finally, adoption of the proposed treaty would also be in conflict with the International Air Transportation Fair Competitive Practices Act of 1974. Congress enacted that legislation in order to bring to an end a variety of unfair and discriminatory competitive practices, including discriminatory tax practices, against U.S. international airlines by foreign countries. Foreign countries will have reason to question the real intention of the United States government concerning discirminatory practices if this treaty is ratified. Such policy inconsistency should be disavowed.

ADVERSE PRECEDENT

During the negotiation of the proposed treaty last year, the Treasury Department indicated to us that the Philippine negotiating team was firm on the elimination of the reciprocal exemption, but would agree to reduce the gross billing rate from 2½ percent to 1½ percent. Our response to this offer was that reference to any rate would be an unacceptable departure from the established reciprocal exemption policy. We did indicate to Treasury that a provision similar to Article 9(2) of the proposed treaty would be the lesser of two unacceptable alternatives. However, we made it clear to Treasury that, if the language that now appears in Article 9(2) was incorporated into the treaty, we would oppose ratification because anything less than preservation of the traditional exemption would be unacceptable to us for all of the reasons we have given.

In this connection, it should be noted that Article 9(1) of the treaty provides for a tax on gross revenues from shepping at a rate not in excess of 1½ percent. We are not aware of any opposition to that provision by the shipping industry. However, the recently released report of the House Ways and Means Committee's Task Force on Foreign Source Income calls attention to a tax avoidance problem within the shipping industry not present in the airline industry. The problem cited is the potential for U.S. owned or operated ships to be held in a foreign corporation, the income of which of which would not be subject to U.S. taxes.

Since all aircraft of a U.S. international airline must be registered within the United States, there is no comparable potential for the avoidance of U.S. taxes as there may be in the shipping industry—as a matter of fact, the Task Force strongly recommended that Treasury renegotiate for shipping without affecting air transportation.

If the Committee ratifies this treaty in its present form, the precedential impact of such action on U.S. airlines cannot be avoided by committee report

assurances indicating this is an isolated or special case not to be regarded as a new policy. Such disclaimers would have little effect upon the positions of other countries. They would look to what was done, not what was said. If the bottom line is the departurt from the consistent policy of the United States, and if that departure is made over the vigorous opposition of the U.S. airlines, it would be understandable for other countries to regard it as a precedent which they would be entitled to adopt despite whatever self-serving contrary statements appeared in the record.

The proposed treaty would set a precedent for other U.S. tax treaty negotiations. The Treasury Department has recently announced that it is contemplating negotiations with 14 countries. To the extent that this Committee approves a departure from the reciprocal exemption concept, it can be expected that other countries will demand similar treatment. The effect on U.S. airlines would be serious.

If the Committee ratifies the proposed treaty, such action would pose a significant threat to U.S. airlines of increased tax costs. It is not possible to estimate the potential effect because, once the precedent has been established, other countries—both developing and developed countries—could advocate similar treatment with even broader exposure. Therefore, incorporation of the reciprocal exemption by the Committee would avoid substantial costs to the U.S. airlines and revenue loss to the U.S. Treasury.

CONCLUSION

We respectfully urge the Committee to withhold ratification of the treaty pending further review and appropriate revision of Article 9(2). We strongly urge that instructions be given to the Treasury and State Departments to renegotiate Article 9(2) to obtain agreement on the incorporation of the reciprocal exemption precluding double taxation of international airlines consistent with long-standing U.S. tax treaty policy, the recent Treasury Department model treaty, the current O.E.C.D. draft treaty, and the other tax treaties now pending before the Committee.

We understand that the International Economic Policy Association is filing a statement with the Committee similarly indicating opposition to Article 9(2) of the proposed treaty, and recommending incorporation of the reciprocal exemption.

Senator CHURCH. We will certainly take up your objection with the State Department and the Treasury Department.

REINSTATING AIRLINES IN PROTOCOL

In Mr. Woodworth's statement, he says:

I believe we could, however, if the Senate so advises, ask the Philippines to reinstate airlines in a protocol treaty, subject to a maximum tax of 1.5 percent of gross receipts on outbound traffic, or any lower rate agreed to by the Philippines in a treaty with a third country.

I take it that you would be opposed to that?

Mr. PHILION. Yes, Mr. Chairman. We would have to question why Treasury believes it is necessary, in order to get a treaty acceptable to both parties, to sanction a Philippine discriminatory tax, and one which flies in the face of longstanding U.S. policy.

PAYING TAX RATHER THAN SANCTIFYING PRACTICE BY TREATY

Senator CHURCH. In the absence of a treaty, I take it that you are subject to the 2.5-percent Philippine tax.

Mr. PHILION. That is correct, Senator.

Senator CHURCH. You would prefer to pay that tax than to sanctify the practice by treaty, is that your position?

Mr. PHILION. That's right. However, Mr. Chairman, I must say this. I have faith in the ability of U.S. negotiators to negotiate a mutually acceptable agreement. I think that with the sentiment expressed in the U.S. Senate, if you share our concern, as we hope you would, about this particular provision, I think the chances are good that we can negotiate an acceptable agreement or an acceptable treaty.

Senator CHURCH. Very well. Thank you very much for your testimony.

Mr. PHILION. Thank you, Mr. Chairman.

Senator CHURCH. There will be another brief recess before we go to our next panel of witnesses.

[A brief recess was taken.]

Senator CHURCH. Our last witnesses are here at the witness table. They are Daniel G. Smith, the president of the National Association of Tax Administrators, and John J. Lobdell, the president of the Multistate Tax Commission.

Gentlemen, if you can summarize your presentations, we can go to lunch.

[General laughter.]

Mr. LOBDELL. That is an indication, Mr. Chairman, that we cannot refuse.

[General laughter.]

STATEMENT OF DANIEL G. SMITH, PRESIDENT, NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, CHICAGO, ILL.

Mr. SMITH. At its last two annual meetings, the National Association of Tax Administrators, an organization of the revenue departments of the 50 States and the District of Columbia, adopted resolutions expressing its opposition to the provision dealing with the unitary tax concept found in the newly executed tax treaty between the United States and the United Kingdom.

REASONS FOR NATA OPPOSITION TO U.K. TAX TREATY

The compelling reasons for the National Association of Tax Administrators' action in adopting these resolutions were as follows: Initially, ratification of the U.K. treaty will mean a revenue loss for a number of States. There has been some testimony this morning, Mr. Chairman, about those impacts, and there will be people appearing before you tomorrow who can testify more directly as to what the consequences of this treaty, if adopted, would be for them.

Second, the U.K. treaty would establish a precedent for the Federal Government's treatment of State taxing powers as a negotiable item in international dealings.

Mr. Woodworth this morning said that there were some precedents. However, I suggest that they are not exactly parallel to the provision which is found in the U.S.-U.K. treaty. He did say that in a number of treaties with other nations there were nondiscriminatory clauses. I suggest that Federal law and State law prohibit such discrimination, and that these provisions were added to those treaties.

Third, and perhaps most importantly, the ratification of the treaty would create a new problem for the States in their longtime effort to protect State taxing powers against intrusion by Federal action.

LACK OF PRIOR PUBLIC REPORTING AND DISCUSSION

The signing of the U.S.-U.K. treaty was announced in January 1976, without any prior public reporting by the Departments of State and the Treasury and without any prior discussion with the States whose revenues would be directly affected by the treaty's taxing provisions.

Dr. Woodworth this morning said that he had consulted with the States. I happen to have participated in those conversations. Those conversations were explanatory and they took place in June 1977, or 15 months after the announcement of the treaty in a press release.

IMPACT OF ARTICLE 9(4)

The section of the treaty affecting State taxing powers is article 9(4), which provides that in determining the tax liability of a U.K. enterprise, a State or local government may not take into account the income, deductions, receipts, or outgoings of a related enterprise of the United Kingdom, or of any third country related to an enterprise of the United Kingdom.

The impact of article 9(4) is to remove from the State tax base any consideration of the income and other factors of the U.K. corporations located outside the United States.

This means that, if the treaty is ratified, States which have been using the unitary entity-combined method for corporations can no longer apply this method to a U.K. headquartered company.

I would like to point out that there is a difference in the impact of treaty provisions and Federal statutory provisions. Some people have pointed out that many States in devising their system for taxation of incomes of corporations—domestic, multistate, and multinational—most frequently give reference to the Federal Code. Some States take taxable income from the federal income tax return, and modify it and apply their own tax rates. Others even take the Federal tax liability and with some modification apply their rates to that sum.

However, State legislators, if they become aggrieved with or feel discomforted by a change in Federal taxing policy, have the right to change State law at the time of their next meeting. State legislators or Governors are powerless to react to a treaty provision. There is no choice given.

DEPARTMENTS OF STATE AND TREASURY RATIONALE

At the time the treaty was announced, the Departments of State and the Treasury made no public explanation for the unprecedented U.K. treaty provisions. Subsequently, however, the rationale, some of which you have heard this morning, developed by the Departments of State and the Treasury, were expressed in several forms.

When President Ford sent the treaty to the Senate for ratification, he also transmitted a State Department report which gave explicit attention to the fact that article 9(4) represented a departure from all past tax treaties with respect to State taxation.

The Departments of State and the Treasury make the same basic points, which may be summarized briefly as follows.

All tax conventions that the United States will enter into with other nations will contain a basic rule which prohibits each contracting nation from taking into account, in determining tax liability, the income, expenses, and so forth, of related enterprises of the other nation, except to the extent that intercompany transactions are not conducted at arm's length. The Federal Departments assert that article 9(4) is designed to make Federal and State practices uniform in this respect.

The Treasury further states that the unitary method is inferior to the arm's length pricing standard in preventing manipulation of income for tax purposes. The Treasury describes the arm's length standard as the internationally accepted method for dealing with the misallocation of income among related companies, and it extends to individual States the cooperation of the Internal Revenue Service in investigating cases where related companies may not be pricing according to the arm's length standard.

I think if you have listened to and reflected upon the testimony of Commissioner Kurtz, some of the material presented by Dr. Woodworth, and to that presented by Mr. Oosterhuis of the Joint Committee, you will see that the arm's length method is an imperfect system. I think Mr. Oosterhuis gave testimony that in 40 percent of the cases summarized during one given period of time, the arm's length pricing standard was a weak reed with which to refer.

STATES' VIEW OF ADMINISTRATION'S CONCEPT

The States' most prominent response to this concept, as expressed by the Administration, is that the U.K. treaty abrogates States' taxing powers, and it does so by circumventing the States' guaranteed protections.

Article 9(4) represents a drastic departure from the historic relationship between the Federal and State governments in determining the taxing powers of each. Ratification of the treaty would achieve this result by depriving the States of their not unreasonable right to have a full congressional review of the issues involved. The House of Representatives will have no opportunity to render judgment on the impact of article 9(4) of the text of the treaty.

Equally pertinent is the States' view that the arm's length pricing standard is a weak device on which to justify a departure from the basic constitutional procedures which have protected State taxing powers. States which have been confronted with the operation of the arm's length pricing standard express grave doubts as to whether this method can ever be effective.

An article which appeared in the Harvard Law Review in April 1976, in an extensive note, discusses the Federal Government's present system of allocating the income of multinational corporations. The

article takes a favorable view toward the unitary concept and concludes that the arm's length pricing method is of questionable value, and it suggests that the unitary concept, as employed by a number of States, more than three, as has been indicated by prior testimony, might be regarded with some favor and given some serious consideration by the Federal Government in taxing multinational-related affiliated corporations.

Thus, against this background, the U.K. treaty projects a most unusual situation. In effect, it places the Federal Government in a position of telling the States that they must give up a method which the Treasury apparently has had to use time and again. At the same time, the Federal Government has told the States that they need not fear a loss in revenue because they will be protected by a method which the Treasury has not been able to administer adequately.

The States are deeply concerned over Federal action which serves to curtail their taxing authority. They have two principal concerns in this regard, which may be summarized as follows.

Most State budgets are tightly balanced. Now, there are some States which are enjoying a slight surplus, but I am not so sure that that will continue into the future. So, even a loss of a small amount of revenue can create fiscal difficulties. Necessarily, the States view with apprehension any Federal action which, in itself or as a precedent, could serve to diminish State revenues.

Second, in the past decade, the States have been confronted by several Federal proposals which would limit their taxing authority, impair taxpayer equity, and adversely affect their ability to administer their taxes.

In each instance, the proposals were based on misconceptions as to the operation and impact of State laws. Fortunately, the States were able to convey to Congress the full import of the proposals as they related to State tax administration, and, in each instance, Congress supported the States' position.

The States view article 9(4) in the U.K. treaty as a further effort to impair State tax administration and tax equity for the benefit of a small segment of the taxpaying public—some multinational corporations.

The States point to the failure of the Treasury and State Departments to consult the affected States before drawing up the treaty. The States point to the fact that the unitary system, which would be barred by article 9(4), has long been upheld by the courts and is regarded as an equitable and an effective means for apportioning corporate income. The States point to the fact that if article 9(4) were ratified, it would establish a strong precedent for the further manipulation of State tax systems at the Federal level at the expense of State administrative effectiveness and of the equity of State tax systems. They, the States, respectfully recommend rejection of this provision of this treaty by your committee.

Thank you, Mr. Chairman.

Senator CHURCH. Thank you very much.

[Mr. Smith's prepared statement follows:]

PREPARED STATEMENT OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS

At its Forty-fourth Annual Meeting in June 1976, and again at its Forty-fifth Annual Meeting in June 1977, the National Association of Tax Administrators, an organization of the revenue departments of the fifty states and the District of Columbia, adopted resolutions expressing its opposition to a provision in the newly executed tax treaty between the United States and the United Kingdom. The resolutions reflected the state tax administrators' great concern over the treaty because it restricts the states' method of taxing multinational corporations. Copies of the two resolutions accompany this statement.

There were several compelling reasons for NATA's action:

Initially, ratification of the U.K. Treaty will mean a substantial revenue loss for a number of states.

Secondly, the U.K. Treaty would establish a precedent for the federal government's treatment of state taxing powers as a negotiable item in international dealings.

And, thirdly, and perhaps most importantly, the ratification of the treaty—with this objectionable provision—would create a new problem for the states in their long-time effort to protect state taxing powers against encroachment by federal action.

This statement will seek to explain why, universally, the states are concerned over the treaty even though its impact on state revenues is of limited scope, and why they have repeatedly expressed unanimous opposition against its ratification with a provision which would restrict state taxing authority.

THE U.S.-U.K. TREATY

The signing of the U.S.-U.K. Treaty was announced in January 1976, without any prior public reporting by the Departments of State and Treasury, and without any prior discussion with the states whose revenues would be directly affected by the treaty's taxing provisions. The section of the treaty affecting state taxing powers is Article 9(4), which provides that in determining the tax liability of a United Kingdom enterprise, a state or local government may not take into account the income, deductions, receipts, or outgoings of a related enterprise of the United Kingdom, or of any third country related to an enterprise of the United Kingdom.

The impact of Article 9(4) is to remove from the state tax base any consideration of the income and other factors of the United Kingdom corporations located outside the United States. This means that, if the treaty is ratified, states which have been using the unitary entity-combined method for corporations generally, can not longer apply this method to a United Kingdom-headquartered company. For the state of California alone, the revenue loss due to Article 9(4) in the year 1975 has been estimated at $125 million.

THE FEDERAL GOVERNMENT'S POSITION

At the time the treaty was announced, the Department of State and Treasury made no public explanation for the unprecedented U.K. Treaty provision. Subsequently, however, the rationale of the Departments of State and Treasury was expressed in several forms.

On June 24, 1976, when President Ford sent the treaty to the Senate for ratification, he also transmitted a State Department report which gave explicit attention to the fact that Article 9(4) represented a departure from all past tax treaties with respect to state taxation.

The Departments of State and Treasury have also explained their position on Article 9(4) in letters received by NATA headquarters and by individual state tax administrators. In general, both the State and Treasury Departments make the same basic points, which may be summarized as follows:

All tax conventions the U.S. has entered into with other nations contain a basic rule which prohibits each contracting nation from taking into account, in determining tax liability, the income, expenses, etc., of related enterprises of the other nation, except to the extent that intercompany transactions are not conducted at arm's length. The federal departments assert that states which

employ a unitary method nullify this treaty provision, and Article 9(4) is designed to make federal and state practices uniform in this respect.

The Treasury further states that the unitary method is inferior to the arm's length pricing standard in preventing multinational corporations' manipulation of income for tax purposes. The Treasury describes the "arm's length standard" as the internationally accepted method for dealing with the misallocation of income among related companies, and it extends to individual states the cooperation of the Internal Revenue Service in investigating cases where related companies may not be pricing according to the arm's length standard.

Also, the federal departments assert that because of the burden of unitary method record keeping, foreign parent corporations with affiliates doing business in states using the unitary method have found tax compliance extremely burdensome.

THE STATES' VIEW

NATA's resolutions in opposition to Article 9(4) reflect its firm belief that the states individually affected have an adequate response to each of these federal arguments.

The states' most prominent point is that the U.K. Treaty abrogates states' taxing powers—and it does so by circumventing the states' constitutional protections.

Article 9(4) represents a drastic departure from the historic relationship between the federal and state governments in determining the taxing powers of each. Ratification of the treaty would achieve this drastic result by depriving the states of their constitutional right to have a full Congressional review of the issues involved. The House of Representatives will have no opportunity to render judgment on the impact of Article 9(4) on state taxing authority.

Equally pertinent is the states' view that the arm's length pricing standard is a weak reed on which to justify a departure from the basic constitutional procedures which have protected state taxing powers. And it may be an even weaker reed on which to guarantee the states' protection against the manipulation of accounts by multinational corporations seeking a tax advantage.

States which have been confronted with the operation of the arm's length pricing standard express grave doubts as to whether this method can ever be effective.

One state tax administrator, in his concern over the U.K. Treaty, has cited an instance where a four-year IRS audit has failed to produce a satisfactory determination of the fair market value of products transferred between a multinational subsidiary and its parent. This administrator suggests that the Treasury's adherence to the arm's length standard is about "20 years behind the states in concept."[1]

And, this view is in no way confined to state tax administrators. The April 1976 issue of the *Harvard Law Review*, in an extensive note, discusses the federal government's present system of allocating the income of multinational corporations.[2] The article takes a favorable view toward the unitary entity concept and concludes that the arm's length pricing method is of questionable value. Some of the reasons stated in the article are as follows:

The special character of multinational parent-subsidiary transactions often makes the arm's length method inapplicable.

A multinational corporation audit may involve thousands of transactions and the cost of gathering information on arm's length pricing—several years after the fact—can be staggering for both the government and the taxpayer.

Even if evidence of arm's length transfers can be located, they are seldom comparable because no two transactions are in fact identical.

And most significantly, the *Harvard Law Review* article asserts that arm's length price standards cannot be administered adequately—and that the Internal Revenue Service, taxpayers, and the courts have often had to turn to improvised methods which seem to correspond more closely to the unitary entity method than to the separate entity theory which the Treasury claims to be following.

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[1] Frederick Boetsch, Deputy Commissioner, Alaska Department of Revenue, letter of April 21, 1976.

[2] "Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code," *Harvard Law Review, April* 1976, Volume 89, Number 6, pages 1202 ff.

The *Harvard Law Review* article concludes that, in view of the problems inherent in the arm's length standard, serious consideration should be given to the use of the unitary entity theory as a formalized alternative to current practice.

Thus, against this background, the U.K. Treaty projects a most unusual situation. In effect, it places the federal government in a position of telling the states that they must give up a method which the Treasury apparently has had to use time and again. At the same time, the federal government has told the states that they need not fear a loss in revenue, because they will be protected by a method which the Treasury has not been able to administer adequately.

The difficulties inherent in the use of the arm's length method are also noted in the *Committee on Ways and Means, U.S. House of Representatives Recommendations of the Task Force on Foreign Source Income* (March 8, 1977). In discussing the arm's length method provided by federal law, this report states as follows:

"This approach already products significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries)."

With respect to the assertion that the unitary system has resulted in burdensome recordkeeping requirements for the taxpayers, the states using this method have reported that multinational corporations have not been required to submit books and records and that the information needed for combined reporting is customarily available from reports prepared by the Securities and Exchange Commission and the International Revenue Service.

RESTRICTING STATE TAXING POWERS

The states are deeply concerned over federal action which serves to curtail their taxing authority. They have two principal concerns in this regard, which may be summarized as follows:

(1) Most state budgets are tightly balanced, so that even the loss of a small amount of revenue can create fiscal difficulties. Necessarily, the states view with apprehension any federal action which, in itself or as a precedent, could serve to diminish state revenues.

(2) In the past decade, the states have been confronted by several proposals which would limit their taxing authority, impair taxpayer equity, and adversely affect their ability to administer their taxes. The states have had to cope with federal proposals which would have created loopholes in state income tax law, would have seriously affected sales tax enforcement by restricting their authority to impose use taxes, and would have deprived them of access to federal tax return information, a highly important element in effective income tax enforcement. In each instance, the proposals were based on misconceptions as to the operation and impact of state laws. The proponents of such proposals reduced the states' concerns in the areas involved to a matter of secondary importance. Fortunately, the states were able to convey to Congress the full import of the proposals as they related to state tax administration, and, in each instance, Congress supported the states' position and rejected the adverse proposals.

The states view Article 9(4) in the United Kingdom Treaty as a further effort to impair state tax administration and tax equity for the benefit of a small segment of the taxpaying public—the multinational corporations. They point to the failure of the Treasury and State Departments to consult the affected states before drawing up the treaty. They point to the fact that the unitary system, which would be barred by Article 9(4), has long been upheld by the courts and is regarded as an equitable and effective means for apportioning corporate income. They point to the fact that, if Article 9(4) were ratified, it would establish a strong precedent for the further manipulation of state tax systems at the federal level at the expense of state administrative effec-

tiveness and of the equity of state tax systems, and they respectfully recommend rejection of this provision by the Senate Foreign Relations Committee.

RESOLUTION UNANIMOUSLY ADOPTED AT THE FORTY-FIFTH ANNUAL MEETING OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, HELD IN WILLIAMSBURG, VA., MAY 30–JUNE 3, 1977

RESOLUTION THIRTEEN

Whereas, the Senate Committee on Foreign Relations has scheduled for public hearings on July 19–20, 1977, a Treaty which contains in Article 9, paragraph 4, provisions which prohibit states from continuing to use a fair and equitable method for determining the amount of income of a multinational corporation attributable to its activities occurring therein, and

Whereas, the secretly negotiated Treaty for the first time in the nation's history restricts state taxing powers and creates a tax preference for multinational corporations, and

Whereas, such action disregards and overrides the continuing efforts of the several states to develop and perfect a uniform approach to determining the income of multistate and multinational corporations, now, therefore, be it

Resolved, by the National Association of Tax Administrators as follows:

1. That Resolution Eight, as unanimously adopted by the National Association of Tax Administrators at its Forty-fourth Annual Meeting on June 17, 1976, is reaffirmed.

2. That it oppose the unprecedented action adopted by the Executive Branch in secretly bargaining away the states' taxing powers, and in particular because such action benefits only the world's largest multinational corporations which have never established that they are exposed to tax on all of their income, nor that their effective tax rate is comparable to the tax rate imposed on local corporations.

3. That the National Association of Tax Administrators continue to oppose restrictive federal tax legislation with respect to multistate or multinational taxpayers, and, if such legislation is mandated, it should not provide preferential tax treatment for multinational corporations, should not permit such corporations to alter tax consequences by the corporate form through which they conduct their activities, nor allow the tax impact to be affected by the geographic location of the parent of a commonly owned group of corporations.

4. That copies of the Resolution be sent to the following: the President of the United States; the Governor of each state; the U.S. State Department; the U.S. Treasury Department, International Tax Section; the U.S. Senate Committee on Foreign Relations; and

5. That the Executive Secretary request permission to attend the public hearing regarding the treaty and urge that the parts thereof relating to state taxes be reserved.

RESOLUTION UNANIMOUSLY ADOPTED AT THE FORTY-FOURTH ANNUAL MEETING OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, HELD IN ATLANTA, GA., JUNE 13–17, 1976

RESOLUTION EIGHT

Whereas, both the Executive and Legislative Branches of the Federal Government have under consideration separate proposals which would override state taxing powers and methods, and

Whereas, the Executive Branch, in total secrecy, took the unprecedented action of negotiating and executing a treaty with the United Kingdom which restricts state taxing methods, and substantially reduces the corporate tax revenues for some states for the benefit of multinational corporations, and

Whereas, the United States House Ways and Means Task Force on Foreign Source Income is considering a proposal by Representative Jones to limit states in determining the amount of income derived from state sources to the federal tax base, thereby permitting multinational corporations to manipulate their income and defer the payment of income taxes by the corporate form through which their activities are conducted, and the geographical areas through which their activities are conducted, and

Whereas, such actions completely disregard and undermine the continuing efforts of the several states to develop a uniform approach to the taxation of multistate and multinational corporations, now, therefore, be it

Resolved, by the National Association of Tax Administrators as follows:

1. That it opposes the unprecedented action adopted by the Executive Branch in secretly bargaining away the states' taxing powers, and in particular because such action benefits only the world's largest multinational corporations which have never established that they are exposed to tax on all of their income, nor that their effective tax rate is comparable to the tax rate imposed on local corporations.

2. That the National Association of Tax Administrators continues to oppose restrictive federal tax legislation with respect to multistate or multinational taxpayers; and if such legislation is mandated it should not provide preferential tax treatment for multinational corporations, nor permit such corporations to alter tax consequences by the corporate form through which they conduct their activities.

3. That each member state of the National Association of Tax Administrators request their state legislatures to enact appropriate Resolutions urging that the treaty provisions relating to state taxes be reserved, and that Congress not approve any restrictive federal interstate tax legislation.

4. That copies of the Resolution be sent to the following: (a) President of the United States; (b) Governor of each state; (c) U.S. State Department; (d) U.S. Treasury Department, International Tax Section; (e) U.S. Senate Committee on Foreign Relations; (f) U.S. House Committee on Ways and Means; (g) U.S. Senate Finance Committee; (h) U.S. Joint Committee on Internal Revenue Taxation; and (i) U.S. House of Representatives Ways and Means Task Force on Foreign Source Income.

5. That the Executive Secretary request permission to attend any public meetings regarding the pending treaty and the task force proposal or similar proposals which may be considered by the House Ways and Means Committee, Senate Finance Committee, or the Senate Foreign Relations Committee, and urge that the parts of the treaty relating to state taxes be reserved, and that any task force or Senate Finance Committee proposal to limit state taxes or state taxing methods be rejected.

STATEMENT OF JOHN J. LOBDELL, DIRECTOR OF REVENUE, STATE OF OREGON, IMMEDIATE PAST CHAIRMAN OF THE BOARD OF TRUSTEES OF THE FEDERATION OF TAX ADMINISTRATORS, AND PRESENT CHAIRMAN OF THE MULTI-STATE TAX COMMISSION, BOULDER, COLO.

Mr. LOBDELL. Senator Church, for the record, I am John Lobdell, director of revenue for the State of Oregon. I am the immediate past chairman of the board of trustees of the Federation of Tax Administrators, and present chairman of the Multistate Tax Commission. I am testifying, in fact, as chairman of that commission.

The Multistate Tax Commission is an association of States that are attempting to work out problems of taxing businesses that operate in multijurisdictions.

MTC seeks to eliminate some of the frustration and the confusion for both business taxpayers and the States.

We presently have 19 full member States and 13 associates.

CONCEPT OF UNITARY VS. ARM'S LENGTH DETERMINATION

I think the question deserves just a little bit of attention at this point, that is, the concept of unitary versus arm's length determination of income subject to liability.

There are really two issues involved in State taxation of multijurisdictional corporations. One is the rates that are applied to the income base; the second is the determination of that base.

I think it is well to keep in mind when we talk about the unitary theory or the combination theory that we are talking about a method that applies only to integrated unitary enterprises, the method used to determine what portion of the profits of that integrated enterprise will be subject to the tax rates of the States.

The second issue that becomes involved in applying that theory is the one of what entities are you going to combine for the purpose of determining those profits. Are you going to simply combine those enterprises where the parent is a domestic parent and the subsidiaries are domestic companies? Are you going to combine in those cases where the parent is a domestic company, and it has both domestic and foreign subs? Are you going to combine in a case where the parent is a foreign company, and the domestics are subs in this country? That is really the issue here.

In the case of the multistate commission, all of the full member States have used the unitary concept in terms of combining domestic parents and domestic subs. The issue of worldwide combination is one that is just growing through the States. There are more than the States of California, Oregon, and Alaska that apply the worldwide theory.

In addition to those States, I am reasonably assured that Montana applies the theory, as does North Dakota, and the State of Idaho has recently adopted as a matter of policy moving in that direction. Where they are in implementing that policy, I am not sure.

ISSUE OF DISCRIMINATION

The next issue you come to is the one of discrimination. It seems to me that with the adoption of the treaty, it provides a new legal argument for other companies that are not directly affected by the U.K. treaty, such as corporations where the parent is a German parent, or where the parent is a domestic parent which has foreign subs. The legal argument that can be made is one of the equal protection clause of the U.S. Constitution.

Whether or not you could prevail with that legal argument is a determination the courts will have to make. Certainly the political arguments that can be made once the treaty is adopted with that particular provision become very strong, in terms of the California, as opposed to the world, problems in attracting financial investments.

There is in every compact provisions that allow modification of the apportionment factors that Dr. Woodworth was talking about, to be modified under proposals by both the company or the State tax commissioners, to take care of the unique cases where property sales and wages will not come up with an equitable or uniform approach.

Just a decade ago, not many States had uniform, equitable, or stable business tax policies. In the intervening years, many States have adopted the multistate compact, and perhaps even more important, other States began to use the principles of the compact in the taxation of multijurisdictional businesses.

State tax authorities were determined to eliminate the multiple taxation of the same profit dollar and the potential evils that existed in negotiated tax liabilities. That is the very same objective sought by business, large and small. Until today, of the 45 States with corporate income taxes, 25 States have adopted the Uniform Division of Income for Tax Purposes Act, and 14 more use formulas that do not differ significantly from the UDITPA formula. Thirty-one States now use the unitary business, or the combination, theory in arriving at the income to be apportioned.

If our goals of uniformity, stability, and equity are the same as the goals of the business community, I wonder why the present paranoia of the few multinationals? My conclusion has to be that the real fear is one of compliance with uniform legal requirements and the end of those negotiated settlements.

Just as the States looked to California for leadership in developing policies that could be uniformly and equitably applied, we also looked to California as an example of professional compliance programs. Through the Multistate Tax Commission, those programs began to be transferred across the Nation.

It is not, then, difficult to understand why a few billion dollar multinational corporations, who find that their fair share of State tax liabilities must also be paid, are somewhat paranoid about the tax policies of the multistate compact. Unfortunately, they are successfully using the what's-good-for-General-Bull-Moose theory to recruit other business, large and small, and apparently some Treasury negotiators as well. It is particularly unfortunate because it is the intrastate business taxpayer and the wage earners of our States who will pick up those tax liabilities if their efforts are successful.

LACK OF STATE COMMENTS

Senator Church, I also recognize that some problems in State tax policies do exist. Certainly, the treatment of foreign source income and both foreign and domestic dividends deserves additional study, study that will allow them to be addressed in the light of all the alternatives. I personally believe that ultimate resolution will require both compromise by the States and perhaps even Federal legislation. But at that time, both State and Federal policies must be adopted under the lights and the view of the public. within the framework of our democracy, and not behind the shrouds of secrecy that sometimes hide treaty negotiations.

Generally, where proposed treaty provisions impact State rights, it has been the rule, rather than the exception, to seek State comments. I know that in the case of my State that has been true in dealings with offshore lands and fisheries issues. It was not true in the case of this treaty.

Here the States have not, even after the fact, been able to determine who the nonnegotiating industrial parties were who were involved in the process of proposing these particular provisions.

We all enjoy an equal right of local self-government. This is what makes our American federal system of government unique. Clearly, Congress does have the constitutional power to regulate commerce

with foreign nations, and among the several States and with the Indian tribes. But, for the executive branch to be allowed to secretly negotiate away the rights of States is, in my view, a perversion of our system of government. That is particularly true when over the last 12 years congressional committees have studied numerous proposals dealing wih this subject and adopting virtually none.

RESERVATION RECOMMENDED

The members of the Multistate Tax Commission urge this committee and its members to recommend that paragraphs 1 and 2 of article 2, and paragraph 4 of article 9 of the U.S.-U.K. income tax treaty be reserved.

[Mr. Lobdell's prepared statement follows:]

PREPARED STATEMENT OF JOHN J. LOBDELL

Mr. Chairman, members of the committee, I am John Lobdell, director of revenue for the State of Oregon, immediate past chairman of the board of trustees of the Federation of Tax Administrators, and present chairman of the Multistate Tax Commission.

The Multistate Tax Commission is an association of states working out problems of taxing businesses that operate in multi-jurisdictions. MTC seeks to eliminate some of the tax frustration and confusion for both business taxpayers and the states.

The commission got started in 1967 when 11 states enacted the multistate tax compact. The compact is an agreement among the states to administer the taxation of multistate businesses uniformly and equitably—to see that businesses operating in several states are only required to pay their fair share of tax in each of those states.

The major goals of the compact are:

1. To establish uniformity, equity, and stability in tax laws impacting multijurisdictional businesses;

2. To operate programs so States can pool their resources to assure tax compliance; and,

3. To provide a structure for businesses to resolve conflicting decisions by two or more jurisdictions.

In January 1977, 21 states were members of the compact and 13 other states were associate members. Those 21 states are Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Indiana, Kansas, Michigan, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, Washington, and Wyoming. (Indiana and Wyoming have subsequently withdrawn from the compact.) Associate members are those whose legislatures have not formally enacted the compact, but who cooperate in the commission's programs.

If our Federal Government had national policies in dealing with the apportionment and taxation of income of multi-national businesses that were built upon even a scintilla of rationality, the issues in paragraphs (1) and (2) of article 2 and paragraph 4 of article 9 of the United States-United Kingdom income tax treaty would not be present in this hearing. Unfortunately, those national policies do not exist, and an environment has been created where sheltering income outside the continental United States is a big business in and of itself.

And all the side agreements between those multi-national corporations and the nations they deal with has cost other U.S. taxpayers billions—substantial revenues are diverted by labeling royalty payments as tax payments (thereby creating questionable credits against U.S. taxes). It is understandable, therefore, that some multi-national businesses have turned to the negotiating tables to avoid their tax obligations to the states. They are attacking state policies under any guise or strategy that is convenient.

Just a few years ago, slightly more than a decade, state tax liabilities of multi-state and multi-national corporations were negotiated in too many states.

The Multistate Tax Commission transferred the California experience in developing and testing fair and uniform approaches to taxation of business income derived from multi-jurisdictional operations to its member states. Most member states then became examples for business tax policies that attempted to treat all business—large and small—intrastate, interstate, and international—uniformly and equitably. In all my years of dealing with state taxation and counseling business seeking to locate in my state, I have consistently been told by those businessmen that the important ingredients they sought in a tax climate were stability, uniformity, and equity in tax policies. The multistate tax compact has provided those elements—so why has someone from the world-wide business community turned to this treaty to escape the application of principles they usually espouse.

As I previously stated, a decade ago not many states had uniform, equitable, or stable business tax policies. In the intervening years, many states adopted the multistate compact, and other states began to use the principles of the compact in the taxation of multi-jurisdictional business. State tax authorities were determined to eliminate the multiple taxation of the same profit dollar and the potential evils that existed in negotiated tax liabilities—the very same objective sought by business—large and small. Until today—of the 45 states with corporate income taxes, 25 states adopted the "Uniform Division of Income for Tax Purposes Act" and 14 more use formulas that do not differ significantly from the Udipta Formula. 31 states now use the Unitary Business (Combination) Theory in arriving at apportionable income.

You would think that the committee on taxation, of the Council of State Chambers of Commerce, would be scurrying across the country presenting plaques to state tax commissioners that promoted and achieved the chamber's goals of uniformity, equity, and stability. Instead, a few members of "COST" have taken to the courts to slow or defeat the efforts of the multistate tax commission—to legislatures of the states seeking repeal of the compact—and seemingly to the negotiation table for international treaties to constrict the States' rights.

If our goals are the same, why the present paranoia of the *few* multinationals? The real fear is one of compliance with uniform legal requirements—the end of negotiated settlements.

Just as the states looked to California for leadership in developing policies that could be uniformly and equitably applied, we also looked to California as an example of professional compliance programs. And through the multistate tax commission, those programs began to be transferred across the nation. It is not then difficult to understand why tax managers in those few billion dollar multi-national corporations who find their fair share of state liabilities must also be paid are even more paranoid about tax policies in the multistate compact—and unfortunately, they are successfully using the "What's Good for General Bullmoose" theory to recruit other business, large and small, and apparently some treasury negotiators as well, to further their self-serving cause. It is particularly unfortunate because it is the intrastate business taxpayer and wage earner who will pick up those tax liabilities if their efforts are successful.

Neither business nor states need U.S. treaty provisions to deal with the taxation of multi-national corporations. We do need more rational federal tax policies dealing with multi-national business.

I also recognize some problems in state tax policies still exist. Certainly, the treatment of foreign source income and both foreign and domestic dividends deserve additional study so that they may be addressed in light of all the alternatives. Ultimate resolution may require both compromise by the states and federal legislation. But at that time—both state and federal policies must be adopted under the lights and view of the public—within the framework of our democracy—not behind the shrouds of secrecy that hide treaty negotiations.

Whereas proposed treaty provisions impact state rights, it has been the rule to seek state comments. Certainly that has been true in the case of offshore lands and our fisheries. It was not true in the case of this treaty. There the states have not, even after the fact, been able to determine the parties involved in proposing these apparent self-serving provisions.

We all enjoy an equal right of local selfgovernment. This is what makes our American Federal System of Government unique. Clearly, Congress does

have the constitutional power "to regulate commerce with foreign nations, and among the several states and with the Indian tribes." But for the executive branch to be allowed to secretly negotiate away the rights of the states is a perversion of our system of government. That is particularly true when over the last 12 years congressional committees studied numerous proposals dealing with this subject—adopting none. (See California attachment 4)

The members of the Multistate Tax Commission urge this committee and its members to recommend that paragraphs 1 and 2 of article 2, and paragraph 4 of article 9 of the United States-United Kingdom income tax treaty be reserved.

Senator CHURCH. Thank you very much for your testimony, gentlemen, and also for your patience today.

It has been a long morning.

The testimony and the written statements our witnesses have referred to will be incorporated in the record.

These hearings will continue tomorrow morning at 9:30 in this same room.

Thank you all very much.

This hearing is adjourned.

[Whereupon, at 1:33 p.m., the committee adjourned, subject to the call of the Chair.]

TAX TREATIES WITH THE UNITED KINGDOM, AND THE REPUBLIC OF THE PHILIPPINES

WEDNESDAY, JULY 20, 1977

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

The committee met, pursuant to notice, at 9:30 a.m. in room 4221, Dirksen Senate Office Building, Hon. Frank Church, presiding.

Present: Senators Sparkman, Church, Clark, and Javits.

Senator CHURCH. The committee will come to order.

Our first witness this morning is Senator Hayakawa from California.

We are happy to welcome you to the committee, Senator.

STATEMENT OF HON. S. I. HAYAKAWA, U.S. SENATOR FROM CALIFORNIA

Senator HAYAKAWA. Mr. Chairman, thank you very much for this opportunity to express my views about the U.S.-U.K. tax treaty which is before your committee. As the junior Senator from California, I find myself in the peculiar position of supporting a treaty, a key section of which is strongly opposed by the franchise tax board of California. I am, of course, referring to article 9, paragraph 4, which, if ratified, will prohibit a State from applying the so-called unitary system to the U.K. parent of a subsidiary doing business in the United States.

UNITARY SYSTEM OF CORPORATE TAXATION

The franchise tax board claims that the implementation of this clause would cost California $120 million annually. I may add that this figure is challenged by knowledgeable tax experts. Undoubtedly, the easy way would be for me to support the position of California's franchise tax board. I would be popular in some quarters. Unfortunately, however, I must act otherwise. But before giving the reasons for my support of the treaty, I would like to make some brief comments about the so-called unitary system itself.

It is well established that in appropriate cases the business of a single corporation may be treated as unitary in nature and that the total income of such a corporation may properly be apportioned under a formula that fairly attributes a proportionate part of the corporation's income to a particular State. When applied in a multicorporate

setting, however, the unitary-business doctrine of combined reporting requires that a corporation with a business location in the State includes in its apportionable tax base not only the entire income of such corporation but also the income of such of its worldwide affiliates as are found by the State to participate with the corporation in a single business unit.

This broad approach to corporate taxation can in effect result in taxation by a State of the income of corporations that have no real contact or connection with the State. Since it is not applied by all States, the unitary-business concept can result in more than 100 percent of a company's income being subjected to State taxation or can result in a company paying tax on an allocable portion of the entire income of another corporation, even though there is not complete unity of ownership between the two corporation; for example, where the subsidiary is only 51 percent owned.

Finally, as it has been interpreted by a few States, such as California, the unitary-business concept results in the income of foreign affiliates being included in the apportionable tax base of a corporation with a business location in the State, even though the activities in the State in no way contribute to the earning of such foreign income.

As indicated, I am opposed to California's application of this unitary business doctrine to multinational corporations. There are two reasons for my opposition. First, I believe it impinges on the foreign relations of the United States; and, second, and most important, it is my sincere belief that the unitary method of taxation is contrary to the best interest of my State.

CONSTITUTIONAL ASPECTS OF TREATY

The franchise tax board argues that the provisions in the proposed treaty are a flagrant usurpation of the State's legislative powers. In reply, I would like to cite the Foreign Relations Law of the United States which, in paragraph 117 dealing with the scope of international agreements, has the following to say:

(1) The United States has the power under the Constitution to make an international agreement if (a) the matter is of international concern and (b) the agreement does not contravene any of the limitations of the Constitution applicable to all power of the United States.

I would also like to cite from the remarks of the eminent lawyer, Charles Evans Hughes, when he spoke in 1929 before the American Society of International Law:

I take the view, which I understand to be that of the Supreme Court, that this is a sovereign nation; that the States, in relation to foreign affairs, are not sovereign States; that if this nation exercised its sovereign power in regulations to other nations it must be done through the exercise of the treaty-making power and in that relation there are no States, there is but one country.

In the past there were some cases when the treatymaking powers of the United States were challenged by individual States, but the Supreme Court ruled in favor of the United States. I will not pursue this subject any further and will leave it to some of the witnesses who will follow me and who are much better qualified than I to plead the constitutional aspects of the treaty.

UNITARY TAX SYSTEM CONTRARY TO CALIFORNIA'S BEST INTERESTS

I now come to my final point, namely, my opinion that the unitary tax system, if applied to multinational corporations, is contrary to the best interests of California.

When citing a loss of $120 million in taxes, the franchise tax board is applying short-range terms, and it is concentrating on one side of the issue. It chooses to disregard the obvious, namely, that a more reasonable tax would act as a powerful incentive for foreign-owned multinational corporations to invest in California or to expand their existing investments.

To put it in simple terms, the California Franchise Tax Board is being million-wise and billion-foolish. It disregards the tremendous economic uplift to California in the form of increased investments, payrolls, purchasing power, and taxes which an influx of foreign-owned companies would provide. Unfortunately, the franchise tax board's arguments neglect long-term considerations. They reflect a small shopkeeper's mentality rather than the perspective of international trade.

My emphasis on the opportunities which California misses is based on considerable evidence. Naturally, I did not have the possibility of conducting a worldwide survey, but I had numerous talks with the Japanese-American Trade Council which strongly supports my point of view. Moreover, the California First Bank, which is a subsidiary of the Bank of Tokyo, had the following to say on the subject:

> Your support of Article 9, paragraph 4, of the pending U.S.-U.K. tax treaty, which will be the subject of a public hearing on July 19 and 20 by the Senate Foreign Relations Committee, will substantially assist the many California firms, such as California First Bank, which are presently being unduly burdened by the combined reporting (unitary) method of tax assessment as presently administered by the California Franchise Tax Board.
>
> "Should you have opportunity to represent the interests of the State of California at these hearings, you may feel free to bring to the committee's attention a significant point relative to the California First Bank, the State's eighth largest bank.
>
> "Arbitrary administration of the assessment method may jeopardize the interests of our some 3,000-plus minority shareholders in the U.S., whose equity may be reduced by assessments based not on our California income but on the worldwide income of our parent bank in Japan.

I also received a supportive letter from the Japan Traders Club of Los Angeles. To save the committee's valuable time, I would suggest that it be included in the record.

> In behalf of Japan Traders Club of Los Angeles, a non-profit California corporation consisting of 280 United States subsidiaries, branch and representative offices of major Japanese corporations, I would like to express my grave concern about unitary taxation in the State of California.
>
> As you know, many Japanese corporations have already invested substantial amounts of funds in California. At the time our member corporations were not aware of their intention to apply the unitary concept to such a degree.
>
> I strongly feel that Japanese investment in the United States should increase in order to create more employment in this country and at the same time help to offset a part of the trade imbalance between the United States and Japan.
>
> We are willing to pay our fair share of corporate tax that relates directly to our United States operations. However, under this unitary taxation worldwide operations of the entire corporate group of companies both in and outside the United States are taken into account. The impact of this method of taxation on

our member firms, especially as it is exerted retroactively for four years, is indeed severe.

If this State, which is geographically advantageous as a part of the Pacific economic basin of Japan, continues to practice the concept of unitary taxation, it will result in the impeding of Japaneese investment in the United States at her gateway.

We are hopeful that through your good offices you will be able to emphasize to the policy and law-makers in the Federal and State Governments that such a taxation method should be eliminated.

REPORTING TREATY FAVORABLY URGED

Mr. Chairman, distinguished members of this committee, you were very kind to give me this opportunity to present my views. I am not going to take advantage of your courtesy any longer. Let me just summarize.

I was elected by the people of California in order to represent their interests to the best of my ability. It would be, of course, politically expedient for me to join forces with the franchise tax board. I am unable to do so. I promised my fellow Californians that I would always have their best interests at heart. I therefore respectfully urge this committee to report favorably the treaty to the full Senate.

Thank you, Mr. Chairman.

Senator CHURCH. Thank you very much, Senator, for your statement.

We have a long list of witnesses this morning, including, I think, the tax representative from the State of California, the comptroller. We will have an opportunity to question you further.

ARGUMENT CONCERNING METHOD OF FEDERAL GOVERNMENT'S DECISION

As I said yesterday, I don't pretend to know whether the unitary act is the best, or the so-called arm's length tax method is best. The argument is made, however, that if the Federal Government is to decide that question for the States, then it ought to be done through better tax legislation that lays out policy and that is passed by Congress, presented to the President, and enacted into law in the ordinary course, and that we ought not to interfere with the right of the individual States to make that choice through the treaty method which involves a single country, in this case the United Kingdom, and attempts in that way to interfere with the right of the States to make a decision on how they are going to tax the affiliates or subsidiaries of multinational corporations.

Do you have any view as to that particular aspect of this problem?

Senator HAYAKAWA. I do believe, Mr. Chairman, that international agreements of this kind ought to take precedence over State taxing powers. Obviously, if there is to be such a tax it should be done at the lower level applicable to all States of the Union.

The important thing about it is that the unitary tax systematically applied in California put California to a great disadvantage relative to other States. I must say very frankly that some of the heads of Japanese corporations I have talked to in recent weeks are seriously thinking of locating in other States, Arizona, Texas, and so on, or even going over to Mexico rather than coming to California.

I do know that Governor Brown of our State has been interested very, very much in attracting Japanese corporations to California.

Senator CHURCH. The State legislature has enacted the unitary tax?

Senator HAYAKAWA. I don't know how long ago it was enacted. It has been on the books for quite awhile, as I understand it.

Senator CHURCH. I raise no question about the constitutionality of proceeding through the treaty route to accomplish this objective, but there are many witnesses who have raised stringent objections to that, not so much on legal grounds as on policy grounds.

I thank you for your testimony.

Senator HAYAKAWA. Thank you, Mr. Chairman.

Senator CHURCH. Are there any questions?

Senator JAVITS. Yes; I wish to make a brief statement, Mr. Chairman.

UNITED STATES FUNCTIONS AS A NATION

I would like to compliment you, Senator Hayakawa, and congratulate you on your vision which rises above the narrow interests of one State, even your own, and encompasses our country. There are only three States that have the unitary tax plan, and as long as they don't run afoul of the total policy of the Nation they are welcome to apply it.

But it seems to me that the struggle over the Bricker amendment, which was a monumental and historic struggle in this country, clearly demonstrated that we are a country, as Charles Evans Hughes has said, and not a conglomeration of States, and the treaty power is as effective a power as the lawmaking power. Therefore, when that power is asserted in the interest of our Nation, every State must understand that if it wishes to belong to the Nation it has to conform to it. Any State can nullify the treatymaking power of the United States in many ways, not just this way. If we are going to stand aside when 1, 2, 3, 4, or 10 States do that, we are not going to be able to function as a nation.

I think this is a very credible struggle. Obviously it is going to be something of a struggle. I am delighted that our chairman has himself said that he is not challenging the constitutionality of the treaty but the policy which we can debate and discuss. It is possible to have implementing legislation if anyone around here feels very strongly that we have to have a revenue kind of statute to preempt the States in this field. There is nothing inconsistent between a ratification of a treaty and implementing a law if that should be found by my colleagues to be desirable.

I think this is a real struggle in terms of the Nation and the business of the Nation. I am very pleased that you have made your reputation as an educator and as a fighter for the civil rights of the right. The civil rights of the left are very often in the front of everybody's thinking and on everybody's tongue, but you have fought for the civil rights of the right and that is just as important. There is no reason why we must discriminate against the middle class or the rich. This is apiece with your general philosophy and your outlook which I think is a very healthy addition to the Senate.

I am very pleased that you are carrying it out in practice.

I don't know what will become of this really intensive debate, but I think you have helped us a great deal by giving us the benefit of your thinking on the basis of the total national interest, which you have done today. Thank you.

Senator HAYAKAWA. Thank you very much, Senator Javits. Thank you Mr. Chairman.

Senator CHURCH. Secretary Woodworth has been requested to return again briefly this morning.

EXEMPTION UNDER PHILIPPINE TREATY

Mr. Secretary, after you left yesterday we had testimony from the Air Transport Association. They are making strenuous objections to the Philippine treaty on the ground that it has exempted airlines from the usual provision that has always applied in previous treaties relating to income, the taxation of these companies by their parent government and not by the host governments. The testimony was that this is a very dangerous step to take, that it will be a precedent, that it cannot be regarded as a single case proposition and, once done, will lead to similar treatment by other countries. We are having you back to give us some additional information on the Government's view on this particular point.

STATEMENT OF HON. LAURENCE N. WOODWORTH, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. WOODWORTH. Thank you very much, Senator Church. I think perhaps if I just give you a little background of what transpired in connection with the shipping and airline provision in the Philippine Treaty it might be helpful. In the initial negotiation the Philippine negotiators were willing to agree to an exemption from income tax for either airlines or shipping companies on a reciprocal basis. This proved to be an important holding point as far as the Philippine Government was concerned. We then asked for an exemption for air transport alone. Again they were unwilling to grant that. Initially we worked out the best bargain we could. The Philippines agreed to reduce their tax 1½ percent instead of 2½ percent. Also, it was made clear that this would be a creditable tax in the United States.

After we had preliminarily negotiated on this basis, Pan American came in to see us and asked that we try again for the reciprocal exemption, and we did. We found again, however, that this was a very strong holding point for the Philippine Government. We talked it over further with Pan American. They asked that the whole provision relating to the taxation of airline profits be eliminated from the treaty, in other words, that the status quo be maintained in that area, if we could not get an agreement with the Philippine Government to provide for a reciprocal exemption. On the basis of their presentation we went back and asked that the airline provision be omitted from the treaty.

I must admit that the Philippine Government representatives had some difficulty in understanding why we would want the provision omitted, because they had agreed to reducing this tax from 2½ to 1½ percent by the original provision.

POSSIBILITY OF PHILIPPINE TREATY BEING PRECEDENT

Senator CHURCH. I think that it underscores the concern of the airlines because apparently they would prefer to pay 2½ percent to the Philippine Government than to have this precedent established in a treaty and approved by our Government and ratified by the Senate and thus they are fearing the infection will spread.

Mr. WOODWORTH. The point I would especially like to make is that we did leave this aspect of the tax law entirely alone in the provision that we renegotiated. Therefore, it is our contention that this is not a precedent for any other case. In treaty negotiating when you reach an impasse between the parties, the way you deal with it, if you can't bargain it out, is to omit that provision from the treaty entirely. It is our opinion that omission of a provision does not represent a precedent for any other case and we think it would not be viewed as a precedent in this case. Therefore, it is our opinion that having omitted the provision from the treaty, in the way that the Pan American Airline requested, we have not created a precedent. Now we could, I am sure, obtain a protocol on this point if the committee wanted. We could either get an agreement from the Philippine Government to reduce its tax to 1½ percent or continue just as we have it leaving the taxation of airline profits out of the treaty entirely.

The advantage in leaving it out of the treaty is just as you have said, Senator Church, then it does not represent a precedent insofar as any other treaty is concerned. We are willing to see it go that way. Now I realize that it was the Air Transport Association that appeared before you, but in our negotiations, we found that it was basically one airline that was concerned about the issue. One other airline we know would have benefited by the originally agreed provision, but the impact would have been much less direct. TWA does not actually have flights to the Philippines, but sales are made there and the original provisions would have exempted them from tax. Pan American, I think, is the primary airline concerned. I am told that Flying Tiger and Northwest Airlines did not really object to the initial provision, but that they have gone along with Pan American in the Transport Association position.

As I have indicated, we do not believe that the treaty represents a precedent the way it is now drafted. That is why we finally negotiated it that way. We want to be sure that you understand that we believe a protocol could be obtained, if the committee wants it.

We think it is not a precedent. In fact omission from treaty coverage is a customary way of dealing with points where you have strong disagreement, and where you can't reach agreement. You negotiate the treaty as best you can apart from that. The very fact that we have omitted the provision entirely from consideration establishes the point that it is not a precedent.

IMPORTANCE OF ENTERING INTO TREATY WITH PHILIPPINES

At the same time we think that it is important that we enter into a treaty with the Philippines because we have relatively few treaties with developing countries. We think it is important that we do develop treaties with these countries. Pakistan and Trinidad and Tobago are the only developing countries to date with which we have tax treaties.

We hope that Korea and the Philippines will be added to the list shortly. I think it would be quite unfortunate to have a precedent set where an item which was omitted from a treaty would prevent the entire treaty from being approved.

The treaty does remove barriers insofar as investment in the United States is concerned. There are some $733 million of U.S. direct investment in the Philippines, and in the absence of this treaty the income from that investment will be subject to a 35-percent withholding tax, in addition to the regular corporate tax, at the time the income is brought out of country. With this treaty, that rate in the case of portfolio dividends will be reduced to 25 percent and the rate on direct investment dividends will be reduced to 20 percent. We think that insofar as American investment in the Philippines is concerned this is an important advantage.

There are also substantial administrative advantages in having a treaty with the Philippines because of our ability to obtain information from the Philippines with respect to those who owe U.S. tax, and vice versa. That is a general policy that we are trying to follow throughout the world.

Finally, we have had a special relationship with the Philippines because of their former relationship with us, and we think it is entirely appropriate and desirable that there be a treaty with the Philippines. Thank you.

[Mr. Woodworth's prepared statement follows:]

PREPARED STATEMENT OF HON. LAURENCE N. WOODWORTH, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. Chairman and members of this Committee: I am here today at the request of the Chairman discuss testimony by the Air Transport Association request of the Chairman to discuss testimony by the Air Transport Association re a provision exempting aircraft registered in the United States from tax in the Philippines.

The Philippines currently has an income tax on airlines of 2½ percent of gross Philippine billings. The Air Transport Association would prefer to have the Philippines treaty not ratified because they fear this would establish a precedent for not including an airline exemption in an income tax treaty.

I would like to make three points:

1. *Ability of the Treasury to Negotiate the Airline Exemption.* From a policy point of view, we strongly advocated an airline exemption. Because Pan Am indicated that it would oppose a treaty with no airline exemption, the Treasury made a second attempt through our embassy in Manila to obtain the exemption. A cable from the embassy last September quoted the Philippines Undersecretary of Finance as saying that there was "no chance" the Philippines could accept the exemption.

We are therefore convinced that the Philippines will not grant us or anyone else an airline exemption. They have not granted it in tax treaties with Canada and the United Kingdom, and we understand that they have not granted it in treaties with other countries. In addition, since the Philippines generally includes a most-favored-nation clause in its shipping articles, if they give America an airline exemption, they would have to give several other countries the same exemption. The Undersecretary of Finance said that because of the most-favored-nation requirement, they will not give the airline exemption to anyone.

2. *Philippines Treaty Does Not Change Our Rights in This Area.* To the extent that the Philippines taxes our airlines, we can tax their airline; and if they tax our airlines on a discriminatory basis, sections 891 and 896 of the Code give us the power to retaliate and tax their airline on a discriminatory basis. The Philippines' negotiators were advised that we would not consider the use of those sections as contrary to the treaty.

3. *Airlines are Choosing to Pay Tax Unnecessarily.* The Philippines was willing by treaty to limit its 2½ percent on gross Philippine billings to a 1½ percent tax on outbound billings. Thus, the airlines could have had a reduction of tax (which we believe we could still obtain by a protocol) as well as having the tax imposed on a narrower base. The airlines preferred no treaty provision. I understand this in the sense that it then does not represent a precedent for other countries. But if this is true then the airlines should have no fear of the present treaty which contains no provision on this point.

While we say the "airlines," we mean that Pan Am preferred not to be covered. It is our understanding that it is primarily Pan Am which is opposing the treaty. It is Pan Am which has been in communication with us on this matter since the beginning. It is our impression that TWA would be helped by the treaty. It also was our understanding that Northwest Airlines and Flying Tiger did not initially object to the provision. We believe that limiting the tax on airlines to 1½ percent by treaty would benefit all airlines, including Pan Am, but we are willing either to include or exclude this provision.

Conclusion. The choice is between setting a precedent of doubtful value to Pan Am or limiting Philippines tax on three-fourths of a billion dollars of other United States investment. The Treasury will, of course, in subsequent treaties continue to insist vigorously on the airline exemption and will only yield the point when we consider that a treaty as it affects all United States taxpayers is sufficiently beneficial to outweigh that strong principle.

Finally, I cannot repeat too strongly that in my opinion there is *no chance* of going back to the Philippines and getting an airline exemption. The choice is between a treaty beneficial to the United States and no treaty.

PERSONS INVOLVED IN CREDIBILITY RULING

Senator CHURCH. Thank you very much. I have no further questions. You were present when we discussed the whole question of credibility of taxes.

Mr. WOODWORTH. Yes.

Senator CHURCH. Can you tell me if Secretary Blumenthal is involved in that matter and who in the executive branch below the President will make this decision, or who will make the final rec-

Mr. WOODWORTH. The general procedure is that a ruling will be initially decided upon by the Internal Revenue Service under the direction of Commissioner Kutrz, who was here yesterday. In the case of rulings involving significant or substantial policy matters it would also be subject to clearance through the Assistant Secretary for Tax Policy in the Treasury Department and through him to the Secretary of the Treasury.

Senator CHURCH. This case will be one that comes not directly from the IRS to the President but through the Treasury Department?

Mr. WOODWORTH. Yes. Ordinarily decisions of that type are based upon an interpretation of the law, the best interpretation we can makes as to what the law actually states. If a ruling involves a major policy matter, and obviously this does, the point will be discussed with the Secretary and, to whatever extent he thinks it desirable, it will be discussed with the President as well. I suppose I will be involved in the decisionmaking process in this area.

Senator CHURCH. We will probably be in touch with you.

Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

PREVENTION OF ESTABLISHING PRECEDENT

Mr. Woodworth, I appreciate your testimony on this Philippine matter. How could we in your judgment establish that it is not a prec-

edent, as seems to be the issue? I agree with you that we have to judge these treaties based upon the aggregate benefits to the country. There is no doubt of the fact that the failure to include the exemption is a detriment but you say it is overbalanced by the advantage of three-quarters of a billion dollars of U.S. business?

Mr. WOODWORTH. Yes.

Senator JAVITS. For example, in respect to other treaties we have declared a certain understanding. Now the difficulty of an understanding here is that it has nothing to do with the interpretation of a treaty. In what other way do you believe we can make it clear so that we serve notice to the world and say to our own constituents who are the airline companies here that we do not consider the mission to be a precedent and that it will not be treated as a precedent?

Mr. WOODWORTH. I should think that a statement in your committee report to the effect that when there is a matter which is in disagreement between the contracting states and, therefore, is omitted entirely from the treaty, that that does not represent a precedent with respect to any other country. It is my opinion that the Treasury Department, in any subsequent negotiation, would take into account the advantages of entering into a treaty with that country, and if we thought the provisions which were in that treaty were substantially to the benefit of the United States we would undoubtedly bring them before you.

If the negotiations were with a country where there is very little American investment, an issue such as this one in the Philippine treaty would be an important factor which would enter into our negotiating position.

Senator JAVITS. What would you say to a letter from the President saying that:

I realize your concern about this question being a precedent. It is not a precedent. It is the policy of the U.S. that we will seek these exemptions. We will regard any departure from that precedent or norm as unusual and we will undertake, if we think it desirable, to bring any such treaty before you to fully justify the special case. You can count on the fact that in our negotiations we will stand fast by the traditional proposition that we seek exemption.

Mr. WOODWORTH. I will be glad to look into that possibility.

Senator JAVITS. Will you do that?

Mr. WOODWORTH. Yes. I might also point out that there are provisions in our tax law now which provide for retaliation where discriminatory taxes are imposed on Americans abroad. I think it is perfectly clear that if this tax is imposed at a heavy rate, much heavier than is true in the case of domestic types of shipping or airline transport, that that could well be viewed as a discriminatory provision and, therefore, we might, in such cases, seek to invoke these other alternatives available to us.

Senator JAVITS. I think it would be interesting if the letter referred to that protection in the case of abuse of the omission in the treaty.

WORTH OF ACT EXEMPTION PROVISION TO UNITED STATES

Mr. Woodworth, knowing you as I do, I know you can switch gears very easily. I was not here yesterday when you testified on the treaty

with the United Kingdom, and I would like to ask you one or two questions on that if I may.

What do you think this ACT exemption provision is worth to U.S. business? You gave the example of the $750 million in business for the Philippines. What is the ACT provision worth to U.S. business?

Mr. Woodworth. You see, this is retroactive to begin with and the retroactive part of it, through 1977, will result in approximately $400 million of ACT payments for Americans.

Senator Javits. How will that benefit the U.S. Treasury?

Mr. Woodworth. It will benefit primarily the shareholders in the United States. There is also some amount of that which will go to individual States in the United States under their rules. State income tax receipts could benefit from these refunds, too.

Senator Javits. It will not be added to corporate profits, or will it?

Mr. Woodworth. The refund does increase income. When the refund is made to direct investors in the United States, it also affects the size of the foreign tax credit which is allowable.

Senator Javits. The size of what?

Mr. Woodworth. Of the foreign tax credit.

Senator Javits. You consider that a net benefit to the United States to have this exemption?

Mr. Woodworth. Very much so. Not only, Senator Javits, because of the British system, itself, but because much of the European world is going to a form of integration of corporate and individual taxes. Germany has it, France has it, Canada to some extent has it. A number of the other European countries either have it or are moving in that direction. Now that type of system can discriminate very heavily against U.S. or other foreign shareholders. This treaty is an attempt on our part to get an early start to be sure that American shareholders are not heavily discriminated against because of any such system.

We think it is a very highly desirable precent that we have obtained in the British treaty, and we believe that it gives us the opportunity to urge similar provisions upon other Western European nations. Without an agreement in this area we think we are at a very severe disadvantage. I would say that this is the most important treaty provision we have obtained in a long, long time.

Senator Javits. Now you speak of shareholders, which concerns the operations of these enterprises giving very large U.S. employment in terms of their ability to compete abroad?

Mr. Woodworth. Yes. When I said shareholders I had reference both to the corporations in the United States and to individual shareholders. The funds that they will have available for providing jobs here in America, or for distributing to shareholders, will be increased.

Senator Javits. But it does affect, does it not, materially the ability of these enterprises to compete abroad with the national enterprises, private national enterprises, of other countries, is this not correct?

Mr. Woodworth. There is no question about that. The provision makes a very substantial difference in the aftertax rate of return. That aftertax rate of return is much more favorable under this proposal than it would be otherwise.

Senator JAVITS. We are feeling the heat of that competition, are we not, abroad?

Mr. WOODWORTH. That is correct.

Senator JAVITS. In a very serious way.

Mr. WOODWORTH. Yes.

VALUE OF RELIEF FROM UNITARY TAX SYSTEM

Senator JAVITS. Now juxtaposing the value to us and the value to the British economy of those elements of the tax treaty which relieve their companies or their enterprises of the unitary tax system, how does that balance out?

Mr. WOODWORTH. In terms of revenue, if that is what one looks at, it is a major advantage insofar as the United States is concerned and a very minor advantage on the unitary side as far as the British are concerned. But I question, myself, whether the net effect is not an advantage even with respect to the unitary provision alone, insofar as the United States is concerned because I believe that this will encourage British firms to invest in the United States and provide jobs here. Just as Senator Hayakawa said, in terms of jobs in the United States it clearly is desirable to follow an arm's length system when dealing with international transactions.

Senator JAVITS. Do you think a unitary tax system, whatever may be the views of any State, is regressive as far as investment of foreign enterprises in the United States is concerned?

Mr. WOODWORTH. I think it tends to discourage companies from locating plants in areas in the United States, and, as a result, it does decrease job opportunities.

JUSTIFICATION FOR PREEMPTION OF STATE UNITARY TAX SYSTEM

Senator JAVITS. How do you justify our national policy as contained in this treaty of preempting the unitary tax system of any given state?

Mr. WOODWORTH. Well, our treaty authority clearly covers limitations on State authority as well as Federal. I pointed out yesterday that perhaps 15 or 20 of the tax treaties that we now have in effect require nondiscrimination in the case of State tax laws as well as Federal tax laws. I also cited an example of another provision in the case of Sweden where, interestingly enough, the supreme court in California ruled that the treaty applied to State taxes. So, I don't think that there is any question that treaty provisions can apply.

On the basic issue as to whether limitations on the application of unitary apportionment should be a broad policy, and this was the point that Senator Church emphasized, I think my answer to that is that treaties by their very nature deal with bilateral situations. Quite often you find, after you have enacted a series of bilateral provisions in some particular area, that it is good general policy, and you then propose it as a general policy.

It is my own impression that this would be a good general policy. I would not have gone along with the idea of having the provision in the treaty if I had not thought it was a good general policy.

Senator JAVITS. Thank you very much. Thank you, Mr. Chairman.

CONGRESSIONAL EFFORTS TO DEAL WITH UNITARY TAX QUESTION

Senator CHURCH. Have efforts been made to get the Congress to have a general tax session to deal with this question of unitary tax?

Mr. WOODWORTH. A task force of the Ways and Means Committee, the Rostenkowski task force, has made a recommendation in this area the effect of which would be to provide an across-the-board rule which is similar in effect to the more limited treaty provision relating only to U.K. parent companies. They have at the task force level reported favorably on this. That was just late last year, and there has been no opportunity yet for consideration of this as a general proposition.

Senator CHURCH. Was the task force just in relation to United Kingdom?

Mr. WOODWORTH. No; it was across the board.

Senator CHURCH. The reason I raised the question is that there are some charges that this treaty route is a method to circumvent the normal process, that Congress, having failed to take any action in this field to deal with this question, is now seeking to deal with it through the treaty route. I wonder what basis there is, if any, for such charges?

Mr. WOODWORTH. I don't recall that restrictions on the international application of unitary apportionment came up for active congressional consideration before the task force studied the so-called Jones amendment last year. There may have been some consideration of it, but I participated to some extent in staff matters, and I don't recall that this was a significant issue, and I don't even recall its being discussed at the congressional level. I have heard discussions of this issue outside of the congressional arena.

Senator CHURCH. Your experience with Congress is such that you are as good an authority as there is on such matters. Do you recall previous bills being included in the Congress?

Mr. WOODWORTH. I don't recall previous bills, but there may have been previous bills. The volume of bills gets pretty large. I would say this. I don't recall the issue ever having been given serious consideration in the Ways and Means Committee until the Rostenkowski task force action.

Senator CHURCH. Thank you very much.

Mr. WOODWORTH. Thank you Mr. Chairman.

WITNESSES AND PROCEDURE

Senator CHURCH. We have 14 witnesses this morning. So obviously we are going to have to impose a time limitation. We will call these witnesses up in panels. The first panel consists of Kenneth Cory, the controller of the State of California, Sacramento; Sterling Gallagher, the commissioner, Department of Revenue, State of Alaska; and Theodore W. de Looze. chief tax counsel, Oregon Department of Justice, Salem, Oreg.

Gentlemen, if you have a prepared statement, in order to avoid repetition, and I think you will have a lot of that, because we know the principal issues, I would appreciate it if you would submit your written testimony and you summarize the main points you wish to

make. That will enable us to ask questions, and it will expedite the hearing.

STATEMENT OF KENNETH CORY, CONTROLLER, STATE OF CALIFORNIA, SACRAMENTO, CALIF.

Mr. CORY. I am Kenneth Cory, controller, State of California, chairman of the franchise tax board. To put the record straight, I am a constitutionally elected officer, elected by the same constituency as Senator Hayakawa. I would presume from his remarks I must have a shopkeeper's mentality. I was unaware of that until I got here. I think there are some major issues. I figured it was a step-up, being a Democrat from Orange County.

Senator CHURCH. You are what?

Mr. CORY. A Democrat from Orange County.

Senator JAVITS. You are a rarer bird than we thought.

Mr. CORY. I spent 8 years representing such bastions of liberalism as Disneyland and Knotts Berry Farm. They always refer to Democrats at best as Socialists. To achieve the status of shopkeeper is a step-up by any standards.

I am pleased to be here to have a chance to discuss our views on something that is affecting this Nation. I am somewhat upset about it. The Treasury Department through the Department of State in negotiating this treaty, I feel, negotiated away our money and our rights without having us involved in it. In fact it was only after the fact that we were apprised of what was going on and even that we had to locate. Nobody bothered to tell us that our money was being sent to England.

I mildly resent that as a tax collector, as a Democrat from Orange County who was told by both the Republicans and Democrats of something that is called States rights.

DEALING WITH MINUTIA SUGGESTED

I clearly understand the constitutional right of the treaty power. The question I think is inherent in that is if the right to decide is the right to decide incorrectly. The purpose I think of our being here is to try to argue the wisdom of the decision and not to try to challenge the Senate into making a decision to prove a point. We accept that you can do it to us. We think it is poor policy on several levels. First of all we think it is poor policy in terms of involving this committee in future minutia, generally speaking, other than the nondiscriminatory clause. These bilateral tax treaties have not involved themselves in the details of taxation. I would suggest to you if you are going to set this precedent you are going to have every special interest group in this Nation trying to figure out a way to get a treaty negotiated to obviate some State tax problem they want to avoid.

This is the classic case in point. This question of unitary method of taxation is relatively complex, and frankly there are no easy solutions to it. But the people who don't like the concept have fought the battle in the courts and have lost. The U.S. Supreme Court for a number of years has said this is an appropriate method of taxation, and it is a fair method of taxation. It is neither arbitrary nor capricious.

There have been numerous attempts contrary to the preceding witnesses' recollection. The testimony that has been submitted in this booklet, the last section, attachhment 4, lists by each bill the various bills since 1965 that have been introduced into the Congress trying to alter the status of the unitary tax concept.

In each case the bills have failed. So, the special interests of this Nation who have tried to avoid this tax which happens to collect taxes from them and perhaps not their competitors, have failed to get a congressional solution. They have seized as a last ditch effort on the treaty mechanism. I think it goes through year by year the various bills. I think you should be aware that I think it is an end run around the normal mechanism. But to turn to the Senate Foreign Relations Committee, with all the weighty problems that you have before you, to deal with local State tax issues—I spent a few days back here calling on Senators and staff people, discussing this issue, and the one feeling I got, although everyone was very polite and very nice, was an overwhelming view from them that they really didn't want to be bothered with our problems because they have other more important problems.

I understand that. I have the same problem on a smaller scale in Sacramento. If this treaty goes through, Treasury has said they plan on negotiating the same policy in other bilateral treaties, and as soon as other interest groups see that they have not been able to achieve their goals through the legislative group, they will be seeking to achieve them through the treaty route. I have better things to do than come here and make this a forum for how States should run their revenue program. I think it is an immediate overriding consideration that should be put into the decision process.

PROBLEMS OF EQUITY OF COLLECTION OF TAXES

The other question which I think should be laid on the record is that in any tax policy there are problems of equity of collection of taxes. Contrary to popular myth, there are not just three States that use the unitary concept. There are some 31 States that use it in one form or another. I think that is significant. In administering it, the model statute, section 18 which in California we call Revenue Tax Code Section 2527 has a mechanism for taxpayers who find that the unitary method does not provide an equitable form of taxation to them, to appeal to the franchise tax board and have an adjustment made if something is incorrect in the format.

There have thus far been 12 requests to the franchise tax board to use that mechanism, only 12 in 10 years. There have only been 12 requests for relief in 10 years. I think that is significant in terms of really how much of a problem it is.

The other thing that I think is very important, and then I will try to curtail my monolog, is the fact that if you look at who it is that is really for this treaty you find in my opinion very limited special interest people. Those people have a right to exist in our Nation, they are a very important part of our Nation, but I don't feel that because of their economic power they should be able to manipulate the Government to their individual benefit. This I think is very im-

portant when you see who it is that is calling upon you in favor of this treaty. I think they are the people who are most able to pay taxes. Whether we like it or not—the field of taxation is one that I have labored in for sometime in California both in the legislature and in the executive branch—nobody likes to pay taxes. Arguments such as "we would stimulate the economy," "there are economic benefits we are not taking into account," are sheer hogwash. We are aware of that economic benefit. But that argument takes you to the position that if we didn't charge taxes at all that would have the greatest stimulus and that would have a broad range effect on people, wage earners, stockholders, everyone.

We obviously can't do that. So it is really a question of whose ox is going to get gored. That is the fundamental issue in all tax questions. That is all that is involved in this. There are some who favor unitary, some who favor another mechanism. To get into that kind of minutia I think is inappropriate. If there are specific questions of how to apply the unitary tax, I will try to answer those. I think there is a very serious policy question that the U.S. Senate should not proceed, not because they don't have the power, but because I think they have more wisdom than to involve themselves into the minutia of State tax policy unless there is an overriding reason to.

I will say to you, in California with only 12 corporations in 10 years asking for relief from this provision it is clear evidence that they don't have a very serious problem. Sure, they don't want to pay taxes. There are people in tax departments who can go up the corporate ladder if they can figure out a way around it. That is the taxation game that is played. But you should not be brought into it. Thank you.

[Mr. Cory's prepared statement follows:]

STATE OF CALIFORNIA

FRANCHISE TAX BOARD

UNITED STATES-UNITED KINGDOM TREATY
POSITION PAPER

HEARING BEFORE THE
FOREIGN RELATIONS COMMITTEE
UNITED STATES SENATE

WASHINGTON, DC
JULY 19, 1977

HON. KENNETH CORY
STATE CONTROLLER
CHAIRMAN, FRANCHISE TAX BOARD

California State
Franchise Tax Board

United States - United Kingdom Treaty

Position Paper

Hearing Before the
Foreign Relations Committee
United States Senate

Washington, DC
July 19, 1977

Hon. Kenneth Cory
State Controller
Chairman, Franchise Tax Board

I am pleased that California has an opportunity to present its views regarding the United States - United Kingdom Treaty. The Treasury provided no such forum, and the Treaty constitutes an attempt on its part to bargain away states' rights and revenues in secret and without consultation with any state.

California first learned of the Treaty after the fact through a routine press release. In California, we believe that if a substantial part of our revenue and taxing powers are to be bargained away, we are entitled to advance notice and to be extended the courtesy of presenting our views in the bargaining process. The Treasury, as indicated in Secretary Blumenthal's recent letter, seems to feel that playing poker with another person's chips without their knowledge is perfectly okay. 1/

The latest published Treaty entered into with the Union of Soviet Socialist Republics, for example, applies only to taxes imposed under the Federal Internal Revenue Code. The technical explanation of the Convention provides:

> The taxes imposed by the Union Republics of the Soviet Union (comparable to states of the United States) are not covered by the Convention because, in keeping with the past U.S. policy the taxes of the state and local governments of United States are excluded from the scope of the Convention, except for purposes of Article X (Nondiscrimination).

Furthermore, the provision included in this Treaty is not included in the model income tax treaty of May 18, 1976, published after the negotiation of the current Treaty. Clearly, the parts relating to state taxes constitute an abrupt change of policy on the part of someone, or a few officials in the Office of the Assistant Secretary of the Treasury for Tax Policy.

California still has not been informed why the Treasury Department chose to take this unprecedented action.

Let us review some of California's concerns if the states' taxing powers can be secretly given away by whoever happens to be the International Tax Counsel in the Office of the Assistant Secretary of the Treasury for Tax Policy.

Upon analysis of the Treaty received with the routine press release in January, 1976, it was found that for the year 1975 the tax of multinational corporations would be reduced by a minimum of 125 million dollars, or more than 10 percent of the

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1/ Letter to Martin Huff, Executive Officer, Franchise Tax Board, February 15, 1977 (Attachment 1)

California corporate tax base. About half of this windfall would go to multinational oil corporations.

After the Treasury Department was contacted by California, the Treaty was revised and a copy was forwarded on May 3, 1976. Although the Treaty by its terms applies only to United Kingdom based companies, such discrimination against corporations located in other countries undoubtedly will result in litigation, the outcome of which is unpredictable. Favored nation clauses in other treaties may automatically engraft this language in these treaties. Furthermore, Treasury Department representatives have said similar provisions will be included in other treaties, if this Treaty is approved. Therefore, the revenue in our estimate, even under the revised Treaty, is at risk. The Treaty applies for the tax year 1975. Because of the retroactive provisions of the Treaty, California's immediate risk is at least 250 million dollars for the years 1975 and 1976, and an ever growing amount as the economy expands.

If the Treaty provision becomes effective, California will have to adopt a special method for determining the income for foreign corporations to minimize its revenue loss. Even if different methods could be legally supported, and there is a serious question that they could be, lengthy litigation is a certainty. Does the Senate wish to give foreign based multinationals a competitive advantage over U.S. based companies?

Material explaining the California taxing method and supporting the rationale of its use is attached. 2/ Briefly, the California taxing method requires commonly owned corporations operated as an economic unit to attribute part of their total income to California by applying to their total consolidated income a reasonable income apportionment formula. The apportionment formula produces a percentage based on the average property, payroll, and sales in California to the total property, payroll, and sales everywhere. Thus, under the California system, the income is determined by the realities of the business and the income it produces. The California taxing method is not favored by many businesses because it eliminates the opportunity to manipulate income by the corporate form through which the business is conducted or through separate bookkeeping records maintained at corporate direction.

California's method for determining income has been used for over forty years, with the approval of the California and United States Supreme Courts in cases involving both domestic and foreign based companies. It is a fair and equitable method for determining income.

2/ The Unitary Concept in State Taxation of Corporate Income (Attachment 2)

The California method differs substantially from the federal method. For federal tax purposes, each domestic corporation is taxed on all of its income, but is allowed a credit for income taxes paid other countries. Foreign corporations are taxed through application of complex rules on income derived from U.S. services. Even though the federal method, in our view, exalts form over substance and requires many complex determinations, the method applied is one that has been adopted as a matter of national policy. Although we are convinced the state method is simpler to apply and is more equitable, the Federal Government should be free to follow its taxing methods, as should the states. Why should the states be prohibited from using a method, which many consider to be better, for determining income of multinational corporations only because they do not parrot the federal practice?

California is committed to the unitary method since it is the most reliable and equitable method which has yet been developed for determining the income of a commonly owned group of corporations engaged in a common economic undertaking. We were pleased when, after a lengthy review and comparison of the federal and state methods for determining the income of multinational corporations, a recent Harvard Law Review note concluded:

> While the unitary entity theory itself is not free from difficulty, it has sufficient theoretical appeal that it deserves serious consideration as a formalized alternative to current [federal] practice. 3/

Mr. Jerome Zeifman, former Chief Counsel of the Committee on Judiciary, after years of examination and comparison of the state and federal methods, is now an ardent supporter of the unitary concept. 4/

Senator Hartke observed when the Trade Act of 1974 was enacted, "that our tax laws [federal] make an overseas investment more attractive than one in Indiana [domestic]." 5/ He concluded that there should be no difference in the tax treatment of corporations operating here and abroad. We believe the unitary concept resolves the treatment of overseas profits of foreign

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3/ Harvard Law Review "Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code" Vol. 89, No. 6, April 1976, p. 1203 at 1238

4/ Address to Multistate Tax Commission, May 3, 1976

5/ "Trade Act of 1974" U.S. Code Congressional and Administrative News, p. 8425

subsidiaries, and of the foreign parents of U.S. subsidiaries as suggested, except that under most state tax laws, no deduction is allowed for either U.S. or foreign country income taxes.

It seems also that the Treasury Department is not aware of the widespread use of the unitary approach by the states. Professor Ferdinand P. Schoettle, commenting on the proposed treaty provision, noted that Secretary Simon, in a letter to Senator Burdick (N.D.), defended Article 9 on the ground that only a "few states" use the unitary business approach to state taxation. The Treasury, when recently asked by Professor Schoettle how many states it counted as using the unitary business doctrine, answered that there were four: New York, California, Alaska, and Oregon. Professor Schoettle observed that the Treasury seemed to be unaware that the regulations of the Multistate Tax Commission adopted the unitary principle, and that 21 states (not including New York) were members of the Multistate Tax Commission. He also reported that one of his students recently counted 15 states with regulations that adopted the unitary business doctrine and another 11 states where the concept had been accorded judicial recognition. 6/

Professor Schoettle's findings are supported by a survey made by the State of Indiana, based upon a questionnaire sent in October, 1976. One of the questions was:

> Are there any situations in which your state goes beyond the corporate shell to consider the unitary corporate business in determining the income tax base? (That is, are there any situations in which your state takes into consideration activities of related corporations in determining the income tax of a corporate taxpayer?) 7/

All fifty states and the District of Columbia responded. Thirty-one states answered "yes," and fourteen said "no." The remaining six states do not impose a corporate income tax. Therefore, almost 70 percent of the states which impose a corporate income tax use the unitary concept to some degree. If the unitary concept is jeopardized by the Treaty, then the method utilized by many states for determining income of multistate and multinational corporations may be doomed.

The only beneficiaries of the pending Treaty limitation are multinational corporations conducting activities in those states which determine their income on a worldwide unitary basis.

6/ "The U.K. Treaty and the State Taxation of Corporate Income" Tax Notes, April 4, 1977, p. 3 at 8

7/ "Survey on Uniformity of State Tax Law" State of Indiana, 1977

Obviously, the direct beneficiaries of the Treaty are United Kingdom based multinationals. In addition, because of "favored nation clauses," equal protection issues and indicated Treasury policy, all other foreign based multinationals are prospective beneficiaries.

Foreign multinational corporations do not need tax preferences to compete effectively in the United States. According to statistics in the Fortune directory upon which a New York Times article was based, multinationals are doing quite well. According to the Times, combined sales of the foreign 500 rose 8 percent in 1975, compared to a 3.9 percent increase for the 500 largest United States corporations. It is further observed that the Royal Dutch-Shell Group topped the foreign list, while British Petroleum was third. These companies would be fully or partly protected by the provisions of the Treaty. 8/

A survey by the European Commission on Multinational Companies found that the greatest concentration of financial power in relation to national output is in the United Kingdom. It was further reported that six United Kingdom financial companies alone have combined assets equal to 95.4 percent of the country's gross national product. 9/ Providing a preference for this group would be ludicrous.

Ratification of the Treaty provision would put the entire unitary concept at risk, leaving the states to the tender mercies of the multinationals. Why else would the U.S. based multinationals be pressing for the Treaty despite the apparent competitive disadvantages they would suffer in relation to foreign owned multinationals?

While the Treaty proposes to extend preferential treatment to foreign multinational corporations, it would seem that a better direction would be for Congress to adopt a taxing system which is neutral in its application, and which would not afford tax preference to operations outside the United States. There have been several studies which indicate that present U.S. [federal] tax policies encourage overseas spending, thereby reducing U.S. employment.

Congress should conduct a vigorous investigation of the actual operation of the present federal system of international tax credits. A major purpose of such an investigation would be to determine the extent to which the credit system has encouraged

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8/ New York Times, August 2, 1976

9/ San Francisco Chronicle, September 25, 1976

foreign governments on both a national and local level to increase their taxes at the expense of the U.S. Treasury.

Prior Secretary of the Treasury William E. Simon's letter of last year said, in part:

> Foreign parent corporations with affiliates doing business in states employing the unitary system find it extremely burdensome to submit all of their books and records concerning all of their worldwide activities in a form satisfactory to the taxing state. This is especially true when only one of a large number of their affiliates does business in the state and their books and records are kept in different languages, in different currencies, and according to different sets of accounting rules.
>
> * * *
>
> I understand your contention that the unitary system is a means of dealing with "game playing" by multinational corporations. I feel, however, that it is a highly imperfect means and a poor substitute for an arm's length standard. Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities or in different locations are always the same. This is clearly not the case. To the extent the unitary system misallocates income. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary system does have the effect of taxing foreign corporations.10/

Mr. Simon's echoing of the objection as to recordkeeping is not valid as we have never required any multinational to physically submit its books and records. In almost all cases the income and data for determining the California tax on a combined basis is prepared and furnished by the corporate managers. In addition, in almost all cases the required financial data is available from reports and supporting schedules required by the Securities and Exchange Commission or for the Internal Revenue Service. The fact is when a corporation is willing to cooperate in having its tax properly determined, the computation poses no problems that multinationals cannot readily handle.

10/ Letter to Governor Hammond of Alaska, dated April 8, 1976

As for the so-called "arm's length standard," which the Treasury advocates, we are attaching for the record a paper discussing some of its numerous defects. 11/ In the Harvard Law Review note, it is stated:

> Furthermore, there is evidence that the pricing test most often used by revenue agents to make allocations in routine international intercompany sales audits is the improvised fourth method (unitary) [added for clarity]. Indeed, one commentator has stated that it is the rule, not the exception, for agents in effect to view commonly-controlled business more as unitary than as separate entities, focusing on the division of net profits between parent and the subsidiary, while at least partially ignoring actual intercompany prices. 12/

At the present time, the Committee on Ways and Means has under consideration recommendations of the Task Force on Foreign Source Income. The Committee Report stated as to the federal arm's length approach:

> This approach already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries). 13/

Even assuming the states could utilize the arm's length approach, the cost to multinationals and the extent to which they would have to open their books for examination would be many times greater than that necessary for the unitary approach.

California does not agree with Mr. Simon's assumption as to the basis of the unitary system. The unitary system recognizes that each step in the business process contributes to the final profit. Through either horizontal or vertical integration, the

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11/ "Critique of 'Arm's Length' Concept" (Attachment 3)

12/ See 3/, supra, at 1223

13/ "Recommendations of the Task Force on Foreign Source Income" Committee on Ways and Means U.S. House of Representatives, March 8, 1977, par. 28

whole is greater than the sum of the parts. The unitary system recognizes this and allocates the overall profits among the various jurisdictions on the basis of the corporate activities in that jurisdiction. The profit of any individual step in the process is ascertained by the application of a neutral mathematical formula approach rather than by an artificial, subjective evaluation of its importance.

Mr. Simon's assumption that profit rates of particular segments of a business can be accurately determined (inferentially by separate accounting) is contrary to common knowledge and case law. As stated by A. L. Monroe, Controller, Exxon Corporation,

> "...the petroleum business is unitary in nature. The most meaningful segmentation of our operations in the 'upstream'/'downstream' segmentation previously furnished for the years 1972-1974. Further breakdowns require many allocations and assumptions, which could lead to erroneous comparisons of data between various companies and hence erroneous conclusions." 14/

The question of the states' taxation of interstate and international business has been before the Congress for some twenty years. A chronology of bills, hearings and reports is attached. 15/ Is it proper for the Treasury to intercede for the multinationals and usurp an area subject to such extended Congressional consideration?

We want to make it clear that our only concern is with respect to the unprecedented provision in this Treaty which prohibits California from continuing a fair and equitable method for determining the income of multinational corporations.

Recently Professor Ferdinand P. Schoettle noted that while government should have a coherent policy concerning state taxation of interstate commerce, he felt it very unwise for the Treasury to allow federal policy to be dictated by the exigencies of a treaty negotiation. According to Professor Schoettle:

> State taxation of United Kingdom income is relatively unimportant. However, the future use by the states of the unitary business doctrine is one of the more important issues concerning state taxation of interstate business that has to be resolved. 16/

14/ Letter to Senator Philip A. Hart, Chairman, Sub-Committee on Anti-Trust and Monopoly, dated January 6, 1976

15/ Summary of California Corporate Tax Law and Federal Legislation, Bills, Hearings and Reports Relating to State Taxes on Corporate Income (Attachment 4)

16/ See 6/, supra, at 4

The policy implications involved in this Treaty provision are of great significance. If your Committee concludes that state taxing powers are to be subjected to the whims of whoever happens to be the Treasury's International Tax Counsel and who is willing to limit state taxing powers for the benefit of a few of the world's most powerful corporations, California feels that such action over time will drastically alter the so-far successful but delicate federal-state relationship.

Accordingly, I urge the Committee to recommend that paragraph (1)(c) of Article 2 and paragraph (4) of Article 9 of the Treaty be reserved, and thereby nullified.

ATTACHMENT 1

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

FEB 15 1977

RECEIVED
FEB 17 1977
Martin Huff, Executive Officer
FRANCHISE TAX BOARD

Dear Mr. Huff:

Thank you for your letter of January 24, 1977 and the copy of your letter to Secretary Vance, concerning objections to paragraph 4 of Article 9 of the proposed income tax treaty with the United Kingdom.

I understand your concern over this provision, but I cannot agree, after careful review of the issue, that the provision should be withdrawn from Senate consideration. I support the objective of the provision and furthermore, I feel that the Senate should be given the opportunity to voice its opinion.

I am sure that the arguments in support of the provision are familiar to you, but I would like to summarize them briefly.

The scope of the provision is quite limited. It will restrict the ability of California to include foreign affiliated corporations of a corporation doing business in California, only when that corporation is controlled by a U.K. corporation (which is in turn controlled by British shareholders). I am aware, as you state in your letter, that this does provide limited preferential treatment for U.K. based multinational corporations. You must bear in mind, however, that a treaty is a negotiated document containing a number of concessions by both partners. In the pending treaty, the United Kingdom made very important concessions, particularly in the treatment of dividends paid to U.S. investors. We view the Article 9(4) provision as an appropriate quid-pro-quo for the concessions made by the United Kingdom.

The unitary apportionment system is inconsistent with accepted tax treaty policy which prohibits one country from taxing the business profits of an enterprise of the other unless that enterprise is engaged in business through a permanent establishment in the first country. Under unitary apportionment, if the profit rate of a foreign member of a unitary group exceeds the profit rate of the member doing business in California, the effect is tantamount to taxing the profits of the foreign enterprise.

Though you state that unitary apportionment is "the most accurate and reasonable method yet devised" for assessing the income of one element in a multinational group, it is our experience, as well as that of most other countries, that the determination of income on the basis of an arm's-length standard is not only more accurate but also far less arbitrary. The arm's-length standard is the internationally accepted approach. Thus, in an international context, the use of another method by one jurisdiction will often lead to double taxation.

The unitary system imposes a substantial compliance burden on multinational corporations. Much of the information required for a combined report with respect to a foreign parent or foreign sister corporation may not be available to the taxpayer. Even where the information is available, the burden of reporting the accounts of many far-flung affiliates on a standardized basis can be great. We are aware of cases where this burden has discouraged foreign investment in the United States.

For all of these reasons, I repeat, the provisions of the proposed income tax treaty with the United Kingdom seem to me wholly appropriate and desirable.

Sincerely yours,

W. Michael Blumenthal

Mr. Martin Huff
Executive Officer
California Franchise Tax Board
Sacramento, California 95867

ATTACHMENT 2

THE UNITARY CONCEPT IN STATE TAXATION OF CORPORATE INCOME

General

When a corporation conducts all of its activities in one state its income for tax purposes is determined by its gross income as defined by the laws of the state less allowable deductions. A problem arises as to how to reasonably apportion or assign its income when it is derived from taxable activities which occur in more than one state.

The department conducted a study 1/ in 1967 which established that approximately two-thirds of the total corporate tax on or measured by income received by California is from corporations which conduct activities in more than one state. Considering economic trends, the present percentage from multistate and multinational corporations is probably considerably higher. The California corporate tax is imposed on or measured by income which is attributable to California sources. In the case of foreign corporations (those incorporated other than under California law) jurisdictional reasons mandate that the tax be limited to California sources, and policy reasons compel the same limitation in the case of domestic corporations (those incorporated under California law). 2/

Determination of Source Income

The two methods for determining income derived from sources within a state are known as "separate accounting" and the "formula method." To apply the separate accounting method, the gross income attributable to the state is determined by examining the individual books of the separate corporations and the deductible expenses are then subtracted. If the business is truly separate and all activities occur in a single state, the net income is accurately determined. If, however, the activities are not a separate business, and activities occur within and without the state, both income and deductions reflect arbitrary determinations which cannot by their nature reflect the interdependency of the activities. A business would be separate if there were no substantial connections other than common ownership. For example, if a corporation operated an antique shop in California, and a television station in another state, the income of each business could be determined by separate accounting.

1/ 1968 Franchise Tax Board Annual Report, pp. 18-19

2/ 12 Hastings Law Journal 42 (1960)

Franchise Tax Board - July 19, 1977

If, however, a corporation manufactured a product outside of California which is sold in California and other states, under separate accounting it would be necessary to determine piecemeal how much of the income and deductions are attributable to each of the various functions and activities conducted in each of the different states. Such an approach is both impractical and unreliable.

Unitary Business

A "unitary business" is a business which is so integrated that it is operated as an economic unit. One of the better summaries of what constitutes a unitary business was set forth by Frank M. Keesling and John Warren, two noted commentators, as follows:

> Briefly stated, for the purposes of allocation of income a business may be defined as a separately owned group of activities each of which contributes to the production or earning of a given identifiable item of income, no portion of which can be segregated and specifically identified as being attributable to any one of the activities or any combination of activities less than the total number included in the group. In some instances, this relationship may exist between all of the activities conducted by a given taxpayer and its entire income. A company which derives its entire income from the manufacture of a product in one state and the sale of the product in such state and other states is a common example of the existence of such a relationship. The income is attributable in part to all of the activities, manufacturing, selling, accounting, management, and purchasing, etc., which must be engaged in to produce the income. No portion of the income can be specifically identified as being derived from or attributable to, any one of these activities. Due to this relationship to the common income, all of these activities may be considered as constituting portions of a single business unit. Since, as indicated, the activities are located in a number of different states, the business is clearly unitary and the formula method should be employed to apportion the entire net income among the various states. 3/

The "unitary concept" was developed because of the unreliability of separate accounting. The reasons for formula apportionment were set forth and discussed by Professor Gary I. Boren, as follows:

3/ See 2/, supra, at 49.

> The basic premise of transactional separate accounting--that it is accurate--is the focus of the successful counter-attack to its use. The argument is that there is no accurate method to separate interstate elements, since income is the result of unmeasurable contributions by all aspects of a business. Any method used by a taxpayer will be subject to objection. Apportionment on the basis of pure geography, i.e., where each item or activity is located or took place, fails to give weight to the effects which these items or activities have on the parts of the business located in other states. A classic example: Increased sales expense in one state leads to increased production, lower per unit costs of manufacturing, and hence more profit on sales in other states. Separate accounting systems which do attempt to recognize the interstate effects of acts occurring in different jurisdictions are similarly vulnerable. Either (1) they utilize mere estimates, based on implied inter-corporate transactions which actually never took place or were not at arms length or (2) they connect items of income with particular places by the use of an arbitrary formula.
>
> It is no answer to the last of these objections (although it is certainly true) that the formula used by the state is also arbitrary. No mathematical formula can determine exactly how much income is derived from a given state, it certainly cannot measure the social costs of a corporation's activities. Therefore some device must be used that is equitable to the state, the taxpayer, and other taxpayers. To this end it must be standard, so it is not subject to taxpayer (or state) manipulation. The device must be administratively feasible; simple enough for determination of taxpayer compliance, and of widespread, if not universal application. And it must give weight to the acts occurring in different jurisdictions. 4/

The unitary contributions may result from activities or decisions which, if considered as isolated acts, may not appear substantial. For example, a multinational corporation may have marketing subsidiaries throughout the world, with various manufacturing units and research laboratories. Each subsidiary, at least to some degree, will be managed as an autonomous activity, with its own plans and as a separate business for determining profit and loss. However, none of the subsidiaries is autonomous, and all are interdependent. For example, if one subsidiary offers to sell the

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4/ "Separate Accounting in California and Uniformity in Apportioning Corporate Income" 18 UCLA Law Review, 478 at 488-89 (1971)

company's product at a discount in one country in order to secure a long-term contract, will not the same discount have to be extended to other neighboring countries without a long-term contract? If it becomes necessary to increase manufacturing capacity, should the area which is undergoing the greatest sales increase expand its manufacturing capacity, or should two or more manufacturing plants be expanded simultaneously, even if for a period of time the increased capacity of either would meet the immediate needs of both areas?

The required responses are strategic decisions which have substantial impact on the businesses' success. Such decisions cannot be made locally, nor are they made by top management alone, without contributions from various levels within the organization. Thus, the unitary concept recognizes, as do modern businesses, that the total activities contribute to, and that the success of the business is dependent upon, a consideration of its total activities.

Application of the Unitary Concept to One Corporation

It is the law of California, and of all other states in most cases, 5/ that if a business is unitary, the apportionment of the total net income subject to tax must be by formula apportionment and separate accounting cannot be used.

The "unit rule" originated in 1876 6/ in real property taxation. Those cases held that in assessing property in the taxing jurisdiction, the value producing qualities of other pieces of property located outside the state must be considered. The "unitary concept" is based upon the realities of the business activities.

Determination of the amount of the income of a unitary business taxable by a state is made by a mathematical formula (hence, formulary apportionment) designed to take into consideration the proportion of a representative set of income producing activities which take place locally compared with those which occur nationwide or worldwide. 7/

5/ Report of the Special Subcommittee on Interstate Commerce, 88th Congress, 2nd Session, House Report No. 1480 Table 5-6, pp. 116-117; and 30 Tax Law Review 611 (1975)

6/ State Railroad Cases, 92 U.S. 975

7/ 30 Tax Law Review 610-611 (1975)

Application of the Unitary Concept to Two or More Affiliated Corporations

The unitary character of a business is not affected by the number of corporate entities through which the business is conducted. The California treatment of a unitary business was explained by Messrs. Keesling and Warren, as follows:

> In any case where a business would be considered unitary if conducted by one taxpayer, it should likewise be so considered even though conducted by two or more affiliated corporations. Just as a state may look beyond its borders and take into account the entire income of a business in arriving at a determination of the amount of income reasonably attributable to the activities conducted within the state, so in the case of a group of affiliated corporations engaged in the conduct of a business, it may look at the total income of the group to determine the amount of income attributable to the portion of the business conducted within the state by one or more of the members of the group.
>
> The authority for this procedure does not rest on any special provisions, such as those relating to the filing of consolidated returns or those which authorize the administrative agency to reallocate income and deductions between related taxpayers in order to prevent the evasion or avoidance of taxes. Instead, the authority is implicit in the general provisions of the law relating to the allocation of income such as California Revenue and Taxation Code section 25101 (formerly section 10 of the Bank and Corporation Franchise Tax Act), which authorize the administrative agency to determine the income reasonably attributable to sources within the taxing state. This procedure likewise does not result in the disregard of the separate corporate entities of the various members of the affiliated group.
>
> These principles were clearly recognized by the California Supreme Court in *Edison California Stores, Inc. v. McColgan*. The taxpayer was one of fifteen corporations owned by one parent corporation which had its headquarters in St. Louis, Missouri. Each of the subsidiaries operated retail shoe stores in a different state. The shoes were purchased by the parent and transferred to the subsidiaries, and the parent exercised close control over all of the subsidiaries. The California Franchise Tax Commissioner (the predecessor of the California Franchise Tax Board), arrived at the income of the California subsidiary by combining the income of all of the corporations and allocating a portion thereof to California by the use of the familiar three-factor formula.

> The court viewed the case as a natural extension of the *Butler Bros.* case which it had decided six years earlier. It concluded that the principles governing the allocation of income of a unitary business were the same whether that business is conducted by one corporation with several divisions, as in the *Butler Bros.* case, or by several corporations with common ownership and control, as in the *Edison* case.
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> The argument was made that if the transactions between the parent and subsidiaries, namely the transfer of shoes at wholesale, were at a fair price just as if made between strangers, then there was no necessity or authority for combining the income of the corporations for allocation purposes. This argument was rejected by the court for the same reason that separate accounting was rejected in this case and in the *Butler Bros.* case, that is, since the business was unitary and the profits arose from the business as a whole, the reasonableness of the intercompany accounting had no relevant bearing on the determination of the income earned by the business in a particular state.
>
> The court also took pains to point out that combining the income of corporations for allocation purposes does not amount to a disregard of corporate entities. Rather, it is a means of arriving at the income attributable to the taxing state by taking into account the integration and interdependency that exist among related corporations. 8/

In a unitary grouping of commonly owned corporations operated as an economic unit, a basic question is whether or not there is an interdependency. The same question is presented regardless of whether the operations concern multistate or multinational corporations. Those who advocate separate accounting accept as fact, the fantasy, that there is no interdependency as to related corporations and, further, that the principal officers' determinations as to what income should be allocated to foreign operations is entitled to a presumption of correctness.

Many urge that if an arm's length standard is applied to intercompany sales, accounting records will reasonably reflect the geographic areas where income is earned. Such, however, is not the case. A multinational corporation has a wide range of tools available for diverting income or expenses. Some of these techniques are set forth in an article by John Rive, as follows:

8/ See 2/, supra, at pp. 57-59

Although governments are increasingly watchful of the use of transfer prices on goods and services, moving amoung subsidiaries and between parent company and subsidiaries, to shift profits to low-tax countries, the use of transfer prices is still possible to some extent. The parent can transfer profits through royalty charges and management fees and it can mix debt and equity in the subsidiary for the best tax advantages. One means of providing capital to a subsidiary, for example, is for the parent to underprice capital expansion. And the parent can shorten or lengthen payment terms on goods and services sold among units of the company, thus shifting capital about.

Host governments also are aware of the multinational corporation's ability to avoid import duties. When a tariff is imposed or raised, the parent can reduce the transfer price sufficiently to offset the new duty. The host government might offset some of the effect of this, however, by controls on remittance of profits. On the export side, the multinational corporation can shift profits by limiting the exports of Subsidiary X, located in a high tax country, and encouraging the exports from Subsidiary Y, located in a low-tax country.

The threat of devaluation can bring conflicting tendencies. The multinational corporation may hedge, thus hastening the devaluation. On the other hand, if it anticipates that the local government will restrict imports to save foreign exchange, the multinational corporation can generate offsetting capital inflow, thus reducing the balance of payments problem.

The multinational corporation can use several devices to minimize its tax burden in the host country. For example, intracompany loans can be substituted for stock purchases to avoid dividend taxes. The interest on a loan is a business expense, not subject to tax in the host country, whereas dividends of course are taxable profits. Thus dividends are a much more expensive way of remitting funds than is interest or the repayment of loans. Hence a firm is inclined to maximize the loan capital in a subsidiary and minimize the equity. 9/

The recent and still unfolding scandals involving illegal payments to foreign officials, illegal domestic political contributions, and outright bribes in foreign sales situations sheds light on these questions.

9/ "The Multinational Corporation in the LDC: Is There Room for a Broker," Management of the Multinationals, The Free Press (1974)

It seems clear the corporate decisions involving foreign payments in the case of U.S. based corporations were made in the United States, and that, at least in the eyes of those making the decisions, the payments related to the profitability of the total business. This illustrates the interdependency of the common undertaking.

The fact that such illegal payments were made is but another reason for rejecting the fallacy of allowing the decisions of corporate officers to be given a presumption of correctness as to apportionment of expenses or income.

When the activities of almost any multinational business corporation are viewed in their entirety, its unitary nature is apparent. In most cases, the goods and/or services provided are the same everywhere since the common world economy is the integrator.

To illustrate, a major pharmaceutical company may sell drugs through the non-Communist world. It most likely sells the same drugs everywhere, although they are packaged in only a few countries, with perhaps even fewer basic manufacturers, each of which is making a major related family of drugs. Some of the companies may make components which are sold both within and without the company. Research and testing may be carried on in different countries, with the results available to all production centers. In such cases would it be realistic to conclude that the companies' net income can be determined by the separate books of account of any one of the various controlled subsidiaries through which the business is conducted?

While each of the subsidiaries has to be managed as an autonomous business with its own objectives, its own priorities and plans, and its own profit and loss responsibility, it is also apparent there are other significant considerations.

As noted by Peter F. Drucker:

> But at the same time, none of these units is truly autonomous. All are interdependent. It may, for instance, seem to be purely a concern of the subsidiary in a given Latin American country whether to accept an offer from the country's national health service of a contract that guarantees a sizable market for a drug for five years but at a 25 percent reduction in price. Yet such a price concession may set off demands for lower prices from the health services of other Latin American countries—and without any five-year purchase guarantee. It may appear purely a matter for one of the intermediate plants within the system whether it decides to expand its facilities

> because outside customers, that is, other pharmaceutical manufacturers, are increasing their uses of a substance it makes. But this immediately raises the question whether the company's own plants for finished products are to be considered preferred customers whose orders will be given priority, or whether the new outside customers are to be considered as preferred customers, or at least as equals. If the first line is taken, the company decides in effect to optimize its own manufacturing unit's results at the expense of suboptimizing the results of the intermediate unit. If the second alternative is taken, the company decides, in effect, that being an intermediate manufacturer is more advantageous than being a drug manufacturer.
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> These are strategic decisions. They have long-term—and often irreversible—impact. They cannot be made by "the top" alone. They require local knowledge. But they cannot be made locally, either. They affect the whole company and must be made at the top. A multinational strategy which takes into account only the overall company is condemned to futility. Unless it can be translated into specific strategy for individual markets, it cannot succeed. But the multinational strategy which is decentralized, that is, a strategy which considers each unit and each market as an autonomous business, is equally condemned to futility. And it is impossible—theoretically as well as practically—to predict in advance whether the company-wide, overall approach to strategy or the market-by-market approach to strategy will be appropriate to a given situation. 10/

Logic dictates that if a multinational business is engaged in a unitary activity, the geographical location of the parent or subsidiary should be immaterial.

On March 2, 1977, the California State Board of Equalization in an appeal from the action of the Franchise Tax Board wherein the income derived from the California activities of a group of foreign owned corporations were determined under the unitary method, stated in part:

> We are unable to discern any difference when the foreign corporation is the parent rather than the subsidiary. The following quotation aptly summarizes our position:
>
> > It seems clear, strictly as a logical proposition, that foreign source income is no different

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10/ "Management" Harper & Row, pp. 741 and 742 (1973)

> from any other income when it comes to determining, by formulary apportionment, the appropriate share of the income of a unitary business taxable by a particular state. This does not involve state taxation of foreign source income any more than does apportionment -- in the case of a multistate business -- involve the taxation of income arising in other states. In both situations the total income of the unitary business simply provides the starting point for computing the in-state income taxable by the particular state. This proposition, so far as foreign source income is concerned, was recognized in the early Supreme Court case of Bass, Ratliff & Gretton v. State Tax Commission [266 U.S. 271; 69 L. Ed. 282 (1924)]. While the Bass case involved a single corporation, the rationale is just as applicable where a unitary business is being conducted by an affiliated group of corporations, and even though some of the corporations are beyond the jurisdiction of the taxing state. This was, in substance the holding in Edison Stores [30 Cal. 2d 472; 183 P.2d 16] (1947)]. (Rudolph, State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups, 25 Tax L. Rev. 171, 205 (1970).) 11/

Even those who would reject formula apportionment in the case of controlled corporations are not so naive as to suggest that income be determined solely from separate accounting records. Instead, however, of viewing all unitary operations as one unit, they would argue that intercorporate transactions be governed and regulated by a fair market price or so-called arm's length concept as contained in section 482 of the Internal Revenue Code.

EXAMPLE

Assume a vertically integrated United States based company owns a mine and smelter located in Canada and incorporated under its laws. It owns two ocean freighters, registered in Panama by a Panamanian corporation, used for transporting its ore. It owns a fabricating plant located in the United States, which uses all of the refined metal; it has three wholly owned distributors located in the United States, and one in Canada. It also owns and

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11/ Commerce Clearing House, Cal. Tax. Cas. Rep. § 205-634

operates retail stores in the United States, Canada, and Mexico, which sell the fabricated products.

Further assume that:

The mine and refinery cost $50 million; that its annual payroll is $10 million; that it values the ore sold by its separate book of accounts at $70 million; that its depletion allowance, depreciation, and other expenses are $59 million.

The two sea-going freighters it owns cost $20 million; their annual payroll is $2.5 million; the delivered ore is valued at $75 million; and their operating expenses are $2 million.

The fabricating plant cost $40 million; its annual payroll is $20 million; other expenses are $20 million; and the fabricated goods, when furnished to the distributor, are valued at $130 million.

The distributors are located in the eastern, central, and western areas of the United States (none is in California), and one is in Canada; the stores in Mexico are supplied by the United States distributors; the fabricated goods are sold to the retail stores for $145 million; the distribution facilities cost $4 million; and their annual payroll is $900,000, and other expenses are $2 million.

The 170 retail stores in the United States cost $17 million; the stores in Mexico cost 12,500,000 pesos (valued at 8.0¢ to the dollar); and the 30 retail stores in Canada cost $3 million. The original cost of 20 retail stores located in California was $2 million; the payroll $500,000; and California retail sales $15 million. The gross receipts from all retail stores is $200 million; the annual payroll is $10 million; and all other expenses, such as interest, overhead and advertising, are $50 million. Of the total retail sales, according to the separate books of account, sales in Mexico are 125,000,000 pesos; salaries are 1,875,000 pesos; and other expenses are 25,000,000 pesos. The Canadian sales are assumed to be $24 million; the total payroll is $1.25 million; and other expenses are $4.8 million. (It is assumed the cost of each retail store is the same, but that the salaries in Mexico are 50 percent of comparable United States wages; and general expenses for all retail stores are comparable, except that all national advertising and interest expense on general obligations are deducted from United States source income.)

On the separate books of account for each activity and entity, the consolidated income is $23.6 million, and the California retail operations show a loss of $723,500, computed as follows:

NET EARNINGS

(000,000's)

	Mine and Refinery	Shipping	Fabri-cation	Distributors		Retailing			Consolidated
				U.S.	Canada	U.S.	Canada	Mexico	
Sales	$70	$75	$130	$108.75	$36.25	$166	$24	$10	$200
Gross Income	70	5	55	11.25	3.75	45.65	6.60	2.75	200
Salaries	10	2.50	20	.675	.225	8.6	1.25	.15	43.4
Other Expenses	59	2	20	1.5	.5	43.2	4.8	2	133
Net Income	$ 1	$ .5	$ 15	$ 9.075	$ 3,025	$ (6.15)	$ .55	$ .60	$ 23.6

$$\text{California Income} = \frac{\text{20 Stores}}{\text{170 Stores}} \times (\$6.15) = (\$.7235)$$

For determining the income attributable to California under the unitary method, the net earnings would be the same (differences in tax bases are ignored), and a three-factor apportionment formula would be used for attribution to California income derived from California sources. The apportionment factors would compare the California property, payroll, and sales to total sales. Under the unitary method, the income subject to California tax would be $797,600 computed as follows:

APPORTIONMENT COMPUTATION

(000,000's)

Factor	Mining	Shipping	Fabri-cating	Distribution	Retail		Consolidated
					Calif.	Other	
Property	$50	$20	$ 40	$ 4	$ 2	$ 19	$135
Cal.%						2/135	1.48%
Payroll	10	2.5	20	.9	.5	9.5	43.4
Cal.%						.5/43.4	1.15%
Sales	70	75	130	145	15	185	200
Cal.%						15/200	7.5%

$$\text{Avg. Cal. Factor} = \frac{1.48 + 1.15 + 7.5}{3} = 3.38\%$$

California Income 3.38% X $23.6 = $.7976

Assume under the above facts all of the activities are conducted through separately incorporated entities. Under federal law the tax would be as follows:

Mining & Refining Omitted (Canada)	-0-
Shipping Income Omitted (Panama)	-0-
Fabrication	$15M
U.S. Distributor (less Sales to Mexico if DISC formed with 50% deferral) (IRC §§ 991-997)	9.075
Retail Sales	(6.15)
Net Income	$17.925

As the above example indicates, by the mere act of incorporating the unitary activities the income subject to the federal income tax may be reduced by $5.675 million ($23.6M minus $17.925M). The actual revenue difference cannot be determined if activities had been conducted through branches because a federal tax credit would have been allowed against the foreign source income.

The income subject to tax under California law would be the same even though part of the unitary activities are conducted through controlled foreign affiliates. Under separate accounting, California would be deemed to have a loss of over $700,000 even though it provided a market for 7.5 percent of the business product and the business earned $23.4 million.

The same technique would be applied if the parent corporation was located in another country. The only adjustment which would be required is that the parent corporation would determine the income attributable to California in its currency, which would then be translated to U.S. currency.

For example, assume the parent and principal corporation was located in the United Kingdom. Also, that it owned the facilities described in the example. In such cases value of the property, whenever acquired, would be converted into the currency of the parent using historical basis. The factors and income would then be determined in the same manner as in the case of a United States based corporation, except that they would be valued in the parent's currency. After the income attributable to California is determined, the net tax due would be translated from the parent's currency to U. S. currency.

ATTACHMENT 3

Critique of Arm's-Length Concept

In the absence of an election to file a consolidated return, each corporation is taxed for federal income tax purposes as a separate entity. In order to correctly determine the income of each entity, Section 482 of the Internal Revenue Code provides that where two or more organizations, trades, or businesses are owned or controlled by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between them, if he determines it is necessary to do so in order to prevent evasion of taxes or clearly to reflect the income of such trades or businesses.

The authority provided by Section 482 to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer is other than it would have been had the taxpayer in the conduct of its affairs been an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer.1/

In order to police activities between related corporations, it is the talismanic arm's-length standard which the Commissioner must apply in reviewing the intercorporate transactions. In applying this standard the Commissioner is handicapped by a number of dubious assumptions, such as:

1. All transactions up to the time of review were at arm's-lenth.

2. All transactions after the review continue to be at arm's-length.

3. All general expenses are fairly and equitably distributed.

4. There is a fixed fair market price for all products.

5. No tax incentives exist for attributing profits to a particular stage of production.

6. The fair market price is unchanged regardless of production levels.

1/ Reg. 1.482-1(c)

Franchise Tax Board - July 19, 1977

A. Where almost all markets are controlled by one or a few multinational corporations, what is the fair market value for its products? Are not all price determinations arbitrary? For example, in connection with hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, United States Senate, 94th Congress, 1st Session, on S. 2387 and related bills, the Exxon Corporation, in response to a letter from Senator Hart, stated:

> We have prepared schedules showing a condensed profit and loss statement for each of the four major segments of the Company's operations:
>
> U.S. upstream
> U.S. downstream
> Foreign upstream
> Foreign downstream
>
> This segregation of earnings is consistent with data that we have supplied to other Congressional committees. The operations contained in each of the above segments are indicated on the individual schedules. Exxon's financial records are maintained on a corporate basis rather than a functional or segment basis. Since there are market prices for most crude oils, it is possible to divide earnings on an upstream/downstream basis. However, a further division of earnings is not meaningful due to the difficulties related to transfer prices and the allocation of costs.
>
> Similarly, balance sheet data for the individual operations which were requested are not readily available other than gross and net plant for the four segments mentioned above.2/

The unreliability of arm's-length accounting is again clearly demonstrated by another letter from Exxon to Senator Hart, saying in part:

> As for further statements of revenue and expenditure data directly attributable to each of the above-mentioned groupings, our earlier response, together with the above clarifications, indicate that our corporate records are not maintained in that manner nor do our independent public accountants prepare such allocations. As we indicated in our December 16

2/ Letter dated December 16, 1975 Appendix to Hearings, Part 2 p. 1813

response and in responses to other Congressional committees, to the FTC's Line of Business and Corporate Patterns reports, and to the FASB's proposal for segment reporting, the petroleum business is unitary in nature. The most meaningful segmentation of our operations is the "upstream"/ "downstream" segmentation previously furnished for the years 1972-1974. Further breakdowns require many allocations and assumptions, which could lead to erroneous comparisons of data between various companies and hence erroneous conclusions. Data for 1975 will not be available until March 30, 1976. [emphasis added]3/

Some other problems involved in the impossible search for meaningful comparable prices are illustrated by Professor Jerome R. Hellerstein.4/

B. When more than one controlled corporation is involved in a sales process involving more than two countries, it is doubtful that Section 482 can be effectively applied to the entire transaction. For example, if a U.S. corporation establishes two subsidiaries, one located in the Bahamas, and one in South America, can the transactions between the Bahamas and the South American subsidiary be reviewed? It would seem that under these facts if the property is transferred to the Bahamian subsidiary at a modest gain which meets the arm's-length tests, no further review can be made.5/ In this case it seems clear that the review would stop with the sale to the Bahamian corporation, even though the Bahamian corporation resells the product at a huge markup.

According to information furnished by a knowledgeable tax practitioner, a transaction as described above has been going on for many years for federal tax purposes and has never been questioned. This federal tax avoidance gimmick does not work under the combined reporting method utilized in California and other states since the income of the combined group would be the same regardles of intracompany pricing.

The adverse federal revenue impact of this and other types of accounting tricks available to multinational corporations is certainly substantial according to an article in Business Week:

3/ Letter dated January 6, 1976, Appendix to Hearings Part 2 p. 1817.

4/ See Infra, pp. 13-14

5/ 7 Mertens Law of Federal Income Taxation 38.63

"Tax payments made by multinational enterprises are a matter of bookkeeping, chance, and the vigilance of national taxing authorities," says Professor Raymond Vernon of Harvard's Graduate School of Business.

Multinational business generates more tax revenues than the entire economy of most nations. American companies pay taxes into the treasuries of scores of countries at rates varying from less than 5% to more than 50%. To minimize the taxman's bite, corporations have devised complex strategies:

Adjusting the "transfer prices" of goods exchanged among affiliates and between the affiliates and the parent company.

Deferring taxes by squirreling income away in tax havens. U.S. multinationals had accumulated more than $400-million of tax-deferred earnings in tax havens by 1968, according to Commerce Dept. figures.

Lumping together income from their foreign affiliates so that less of it goes to tax collectors in the U.S.

At stake in the global game is a tax take that could top $4-billion this year. In 1968, the latest year for which figures are available, the Treasury estimates that U.S. multinational companies paid about $3-billion on their overseas earnings. More than $2-billion went to foreign governments. The Internal Revenue Service credits taxes paid abroad by subsidiaries of multinational companies against the taxes owed by the parent company to the U.S. on their foreign operations. So the U.S. Treasury got only $700-million, mostly from taxes on royalties, management fees, and other payments by foreign affiliates to U.S. parents. [Emphasis added.]6/

C. As noted under A, while separate accounting is a useful tool for approximating the earnings of a particular activity, so many variables are possible that management, at its sole discretion, often can control the operations which realize the greatest profits as well as the accounting period in which the profits are recognized. Some of the more common techniques are:

1. To adopt a new method for valuing inventories (LIFO, FIFO).

2. Reallocate overhead.

6/"The Multinationals Ride a Rougher Road" Business Week December 19, 1970.

3. Change the types of income-producing activities to which research and development expenses are charged.

4. Capitalize and amortize various research and experimental expenditures.

5. Lend funds to a subsidiary at an interest rate higher than the rate at which the funds were borrowed by the parent.

6. Furnish interest-free funds to subsidiaries.

7. Conduct overseas operations through a branch while starting up, and through a foreign subsidiary as soon as the operations are profitable.

8. Furnish know-how or technical information at a fee above or below costs.

9. Take advantage of interest rate differentials. For example, make prepayments to subsidiaries in countries with high interest charges, and delay intrafirm payment of accounts receivable to subsidiaries in low interest nations.

10. Establish "letterbox" sales subsidiaries in tax preference countries which buy goods from associated companies at low prices which are then marketed for big profits.

A multinational corporation can substantially control in which countries, at which times, and in which amounts it and its subsidiaries realize income by using any or all of the above or similar techniques.

Some of these techniques that are utilized by a multinational corporation are reflected in the following excerpt from an article by Robert B. Stobaugh, Harvard Business School Professor and coauthor of "Money in the Multinational Enterprise":

> As almost everyone understands, services include such things as transportation, banking, insurance, and tourist facilities. They also include the international movement of know-how. Not everyone is aware of what this means in the operation of multinational enterprises.
>
> In theory, the parent firm receives management fees for its management know-how; license fees and royalties for its technological know-how, trademarks, and patents; and interest, dividends, and branch earnings for its capital. The conventional notion is that you

> send a dollar abroad and in return you get dividends or interest, and you send know-how abroad and get back a separate fee or royalty.
>
> In practice, though, there is no one appropriate price that can be placed on each of the elements of know-how, rights, and capital passed to a foreign affiliate. Regardless of the desires of governments, and at times, firms, to have each transaction between related members of an enterprise system conducted on an arm's-length basis, there is an inherent degree of arbitrariness in the form, as well as the amount, of funds withdrawn from abroad by the parent firms.
>
> Furthermore, the total volume of these elements is apt to be greater than the market prices of the individual elements, and this total value increases according to the degree that the affiliate is operated not as an isolated firm but as part of the multinational system.
>
> The increase in value is brought about by the very nature of the multinational enterprise, its expertise, its central decision-making and supervision, its patents and processes, and all the rest. The intangibles—the services—are far more important than the goods and money that are sent to subsidiaries. And the monetary return for the services far exceeds the payments that are actually labeled fees and royalties. [Emphasis added.]7/

An example of the potential impact of one of the above techniques is a regulation now under consideration by the Treasury Department. The proposed regulation would require multinational companies to charge more of their expenses, particularly research and development, against foreign income. According to the companies, such change would cost them more than $1 billion in higher federal taxes each year.8/

Some of the accounting techniques used for juggling the earnings of corporations are described as follows:

> The secret of the growth of the conglomerate movement centers on "earnings." A company which keeps increasing its earnings, particularly through growth by merger, has been endowed by Wall Street with a high price-earnings ratio. That means simply the relation between the price of a company's stock and its earnings. For example, if a company with annual earnings of $1.00 per share is selling for $50 a share, it has a price-earnings ratio of 50 to 1. If another company's

7/ Wall Street Journal June 6, 1973

8/ Tax Notes, Vol 4 No. 8, p. 3 (1976)

stock with the same earnings is selling for $10 per share, it has a price-earnings ratio of 10 to 1. The trick is to hypnotize the big investors on the stock market into giving one's stock a high earnings ratio. The company with the highly valued stock, then, has the ability to buy up companies with the low-valued stock regardless of their comparative assets. Its strength comes not from its internal structure, but how it is rated by big investors.

There are several basic ways to increase earnings—greater efficiency, acquisitions, and appropriate accounting techniques. If our contention is correct—that conglomerates are not necessarily geared to efficiency—then it becomes clear why many of them must keep gobbling up efficient, high-cash-flow companies. They need their acquisitions' earnings. They also are able to utilize accounting options to inflate these earnings. *Forbes* quoted the head of a leading Wall Street investment firm as saying: You don't have to be in our end of the securities business very long before you realize that what companies call their earnings can be almost anything they want them to be." The same article related: "A partner of one of the Big Eight firms says frankly: 'Give me the books of almost any company and within a year's time I can double the earnings.'"

Abraham J. Briloff, an accountant, told the Senate Subcommittee on Antitrust and Monopoly how this can be done:

> So it is that when it was the managerial objective to reduce income to an irreducible minimum (consistent with what was then deemed to be the "normal growth curve") we were able to accommodate their "Twiggy-Figure" objectives by giving them LIFO (Last In, First Out) inventories, accelerated depreciation, fast R & D and intangible write-offs of oil company development costs, and the like. . . .

He explained that it was this pattern of value suppression which gave rise to the observation that a balance sheet is like a bikini bathing suit—what it reveals is interesting; what it conceals is vital. He continued:

> It might be fairly asserted that it was this very traditional commitment to "a conservative balance sheet," low-earnings reporting, and high liquidity with low debt, which made life so simple for the flamboyant conglomerators, for the performance oriented new breed of management determined to show flair, synergism, flash, and charisma . . .
>
> You see, when the new breed of managers moved into the flesh-pot of assets nurtured by the traditional management, they were capable of disposing of them at huge profits when compared with the vestigial written-down book values—producing still greater earnings exposures by the new manage-

> ment and then when the new management relaxed the old "Twiggy-accounting" constraints, the reported earnings zoomed still more and the high priests of Wall Street were unqualifiedly certain that they had oracular powers approaching the divine. And this could, theoretically, have permitted the chain reaction to continue until all of our economic resources would have been brought within the ambit of the entity capable of being blessed with the highest P/E [price-earnings] ratio.

The *Wall Street Journal*, in a story entitled "Conglomerate Earnings: Credibility Gap," gave an example:

> Merger specialists say that conglomerates "have pointed the way" by acquiring companies with disparate operations and then manipulating accounting rules to their advantage. AMK Corp., a diversified conglomerate, was able to boost its fiscal 1969 profit 74 cents a share over the previous year, for example, simply by three accounting switches. Without these, its profit would have declined by 25 cents a share. Two of these changes were possible because AMK had just acquired a new subsidiary, John Morrell & Co., a meat packer. AMK shifted Morrell from more conservative to more liberal methods of depreciation and valuing inventory and thereby lowered Morrell's cost and thereby raised total corporate profits . . .

Barron's, a conservative business journal, in an article entitled, "Day of Reckoning? Conglomerates Can't Keep Making Two and Two Equal Five Forever," illustrated how accounting alternatives can make a company look better than it really is:

> Two of the basic principles of accounting are uniformity and consistency, yet Teledyne, Kidde and most of the other conglomerates blithely have used "pooling of interests" for acquisitions effected above book, and "purchase of assets" for companies bought below book. In fact, Gulf & Western somehow managed to use both methods in booking the acquisition of New Jersey Zinc. The accounting technique used is the one that best served their interest in maximizing reporting earnings.

The Securities and Exchange Commission announced in 1969 that it may require a change in these "pooling of interest" rules. The result: near-panic by some of the acquisition-minded firms.

The *Barron's* article also described the use of yet one more takeover device:

> Another serious problem for investors arises from the massive use by conglomerates of convertible securities. As Mr. [Meshulam] Riklis so eloquently explained at a recent seminar on how to effect acquisitions, the theory is "that by the time the debentures (Russian rubles) or warrants (Castro pesos) become due, the company you acquired can generate more cash than they are worth."

The Federal Trade Commission's *Economic Report on Corporate Mergers* aptly summed up accounting techniques used to obscure operating results, hide profit declines, and overstate growth in earnings under the heading: "Accounting Principles as Tool of Deception." The report pointed up the basic problem:

> Clearly, no good economic purpose is served by accounting for acquisitions in a way that gives the acquirer the power to control reported earnings regardless of current operating experience. Current merger accounting provides a hothouse environment for acquirers. Even if mergers do not turn out well from an operating standpoint, acquiring firms can often show higher profits through accounting manipulations. It is ironic that internal growth through new investment may be, purely for accounting reasons, subjected to a more stringent test than growth through merger. As a result, firms investing in new capacity to serve producer and consumer needs may be less favored by the stock market than merger-active firms which do not contribute as much to the real growth of the economy.

The report's summary is instructive:

> It is clear that present requirements for corporate reporting are unsatisfactory and are in need of immediate revision. Various members of the business community are exploiting a range of reporting alternatives that tends to mislead the investing public; this also provides the means for promoting a restructuring of industrial organization in such a manner that the requirements of efficient resource allocation will lack a solid foundation. To view the current merger movement as a single manifestation of entrepreneurial effort to restructure the economy in order to meet the requirements of organizational efficiency is nonsense.

> Conglomerate earnings frequently have been attributable to such financial and accounting sleight of hand. Companies have grown because they could make one dollar in earnings look like ten.9/

The ease by which multinational corporations can manipulate their income was vividly demonstrated by an article which appeared in Business Week, discussing Japanese companies. The article quotes Iwao Tomita, director of Tohmatsu Awoki & Co., one of Tokyo's most prestigious accounting firms, as follows:

> When companies needed to show a bigger profit, they would sell their product to subsidiaries at an inflated price, and it was never sold but just held there on inventory. Or the parent company charged a higher rent to a subsidiary company using its building.10/

The accounting shakeup with respect to the Japanese companies is occurring because after six years the finance minister of Japan has succeeded in convincing some of the top Japanese companies they should comply with a directive to produce consolidated financial accounting statements. The article notes that while some companies are complying with the directive, with startling results in some cases, other companies are simply reducing their subsidiary holdings to less than 50% so they can continue prior practices.

It would be most interesting to know if the Internal Revenue Service has been successful in making a Section 482 adjustment with respect to Japanese multinationals since, in many cases, their income manipulation seems to be obvious.

D. Is there a fair market price for products, and if so, how is it determined?

The following discussion regarding concentrated industries, which includes most basic industries is, from America, Inc.:

> Many basic industries such as steel, use "target pricing." The corporation may set a profit goal, say a 15% return on investment. As demand falls, the corporation may raise prices in order to maintain the target profit. At the same time, companies may cut back production. By thus reducing supply to meet demand, supply and demand are kept in equilibrium -- without cutting prices.11/

9/ Morton Mintz and Jerry S. Cohen, America, Inc., Dial Press (1971) pp. 56-59

10/ Business Week, April 25, 1977, p. 112

11/ See 9/ supra, p. 124

The lack of competition is concentrated, and the absence of a competitive price in such industries is explained as follows:

> One need not pursue the excellent academic studies of lockstep pricing in many concentrated industries to see how it works. The Wall Street Journal is easier reading and makes the point. Articles in the Journal for the years 1964 through 1969 describing price changes, most of which the paper faithfully reports in the major industries, show that in copper, steel, aluminum, chemicals, containers—in one concentrated industry after another—the pattern is depressingly repetitive.
>
> First, one company announces that because of rising costs and other factors it is raising its price, say, 4.2 per cent. The Journal's story then reports that other manufacturers are sympathetic and are studying the move. Within a week all other members of the industry will have raised their prices. The percentage of increase will be the same. The stated reasons also will be the same.12/

The unitary nature of concentrated industries and the necessity for determining the income on the basis of a combined report is clearly demonstrated by the following quotation:

> Dual distribution exists in the petroleum and fuel oil industries, copper and steel fabricating and a host of others. An independent steel fabricator, say, buys steel from a giant producer and processes it into fencing or nails. However, the giant also processes steel into fencing or nails. If the giant decides to squeeze the independent, he has but to raise the price of the steel and drop the price at which he sells the finished products. Generally his total profit remains the same, because he is taking money from one pocket and putting it into another. This may go on until the independent fabricator is driven to the wall. Then the company—in control with competition disciplined—is freer to charge the prices it wants.13/

12/See 9/ supra, p. 129

13/See 9/ supra. p. 146

Even if prices were not controlled in most industries, how can a fair market price be established for products other than for the few fungible goods which are freely traded on an exchange?

For example, what is the fair market price for a new drug? What is a fair charge for the use of a patent? And since almost all processed products differ in some degree, how can a fair market value be established for any such product?

The unreliability of an arms'-length requirement was discussed by Professor Hellerstein in the National Tax Journal. Professor Hellerstein noted that formulary accounting was developed because:

> ... there is no viable way of separately accounting for the profits of a business where interdependent operating functions that produce the profits of the enterprise are carried on in more than one state. Thus, to take a simple case, where goods are manufactured in State *A*, and sold in State *B*, efforts to account separately for the profit from these interdependent operations have floundered on the inability to find acceptable methods of breaking up the profit realized into a "manufacturing" profit and a "selling" profit. Two methods of making the segregation are commonly employed: (a) determining the price at which the goods should be deemed to be billed by the manufacturing affiliate or division, by using the prices at which similar goods are sold by other manufacturers to independent customers in the trade; and (b) determining manufacturing costs, and adding a judgment determined "reasonable profit." In both cases central administrative and general expenses are then allocated between manufacturing and selling; and other specific costs for each of the economic steps are likewise separately charged.
>
> The latter step can be accomplished without too much difficulty or too great error, by using normal cost accounting techniques, but the segregation of the "manufacturing" and "sales" profit is a speculative and unreliable process. The major difficulty

in resorting to the prices used by other manufacturers selling to independents is to find a sufficient number of comparable sales under comparable terms and conditions. At the outset, what is the trade to be used to make the comparison? In the motor industry, for example, the evidence must doubtless be broken down, so as to compare the profit on truck sales with other truck sales, not passenger cars; and, with respect to passenger cars, the profits on lower priced mass-produced cars, such as Falcons, must probably be compared with Corvairs, although Chevrolets might possibly be comparable, but probably not with Lincolns or Cadillacs. In some industries, the major manufacturers do not sell to wholesalers or jobbers, but deal directly with retailers, so that there are no sales of significance to wholesalers or jobbers on which to base the manufacturer's selling price to its sales division. Moreover, if we do not find enough sales of comparable products at arm's length by other manufacturers, we must still account for profit variations, depending on volume of sales, terms of payment, delivery dates, geographical variations, and so forth. All these variations make the search for comparable prices elusive and speculative.

If we turn to the other method of segregating "manufacturing" profit from "selling" profit, by determining the costs of manufacture, and then adding a "reasonable profit," we find ourselves in a similar morass of dissimilarities. Mark-ups vary sharply industry by industry, and are affected by such factors as the ownership of patents, trade secrets, the manipulation of prices where monopoly or oligopoly reigns, special problems involved in the introduction of new products, and the like. To seek to develop standards of normal mark-up over manufacturing costs is difficult enough in dealing, for example, with the women's clothing industry, but becomes hopeless in setting standards for the endless variety of products manufactured by a giant such as General Electric—where, for example, entirely different standards prevail for atomic power stations as compared with mass products such as TV sets and refrigerators. Bearing in mind that State Tax Commissioners must deal both with such conglomerates as General Motors, General Foods, RCA, I.T.&T., and the great oil and chemical companies with their endless variety of products, as well as with the thousands of smaller enterprises which do business across state lines, it becomes apparent that it is virtually impossible to administer a taxing statute that requires the establishment of imputed reasonable manufacturer's profits for American businesses over the country.14/

14/Hellerstein, XXI National Tax Journal, 487, 500 and 501 (1968)

The impossible task which an arm's-length standard is assigned because of the mandate that the standard be based on transactions of uncontrolled companies is summarized in Mertens as follows:

> The threshold point for applying Section 482 is simply not reached unless the tax benefit involved stems from less than arm's-length dealing, but this must be shown by evidence of transactions of uncontrolled companies unrelated to the taxpayer. No amount of self-examination of internal transactions is sufficient.15/

Other writers also recognize the task is often impossible. Zoltan M. Mihaly, noted the difficulties in intercompany pricing often faced by both tax practitioners and revenue agents alike:

> ... The basic fallacy of the doctrine of the exclusive application of the arm's-length standard is that it is not true that evidence of arm's-length prices can be obtained in every case. Indeed, probably in the majority of the cases, there is no evidence of truly comparable pricing arrangements involving unrelated parties.
>
> Tax practitioners who work with revenue agents auditing intercompany pricing arrangements also often realize that no evidence of truly arm's-length price is available which would support any particular pricing arrangement between the client and its affiliate and that the revenue agent realizes this also. Thus, the insistence of the Regulations on the myth of the arm's-length standard applicable in each case tends to obscure the question how should the intercompany price be determined in the absence of any evidence of arm's-length prices? Unfortunately, no answer has been found and this remains the great unanswered question of intercompany pricing. [Emphasis added.] 16/

15/ 7 Mertens Law of Federal Income Taxation 38.63 (Supplement)

16/ 25 U.S.C. Law Center Tax Institute 731, 749 (1973)

Richard Hoefs said:

Shortcomings of Prescribed Methods

The criticisms of these methods are twofold: First, they assume that a similar transaction between uncontrolled parties can always be found among the taxpayer's activities, and as a last resort, in the general industry. Practically, this is not a valid assumption. The trend in the direction of vertical organization, whereby corporations control all operations in a business cycle from mining of resources to the distribution of the finished product, has in some areas rendered the uncontrolled sale virtually nonexistent.

Second, the Regulations presuppose that the businessman taxpayer is always able to adopt an "arms-length" price as computed by one of the provided methods. They thereby ignore the realities of operating within a competitive world where the businessman is often required to tailor intercompany prices to existing circumstances....17/

In the same article, Mr. Hoefs provides this specific instance of the accounting chaos to the corporations involved in attempting to apply the regulations literally:

The Profit Center

In many companies today, operating and accounting policies have trended toward the establishment of the responsibility of one executive or a group of executives for the results of certain operations known as a profit center. Often the profit center has a geographic responsibility such as the western United States, Europe, the Pacific, etc. At the same time it is not possible to establish corporations which encompass the identical operation of the profit center.

Thus, many times a corporation will have operations involving more than one profit center and a profit center will involve several corporations. Since the interest of management is directed toward the operations of the profit center, the emphasis on accounting usually follows similar lines. As a result, the determination of profit or loss of a particular corporation is inexact because the records are not kept with that objective in mind.18/

...

17/28 NYU Institute on Federal Taxation 603, 613 (1973)

18/See 17 supra, at 616-617

Recent publications demonstrated the difficulties national governments face when they attempt to apply the arm's-length standard.

The United Kingdom has learned through long experience that the complex task of policing multinationals is beyond the power of ordinary local tax inspectors. Accordingly, it has established a special multinational office. The office has been staffed with outstanding inspectors drawn from all parts of the country; it is said to have a higher ratio of senior people than any other section of the tax machinery. It also has a research unit charged with monitoring prices.19/

More recently, the Seventh Annual Institute on International Taxation summarized the results of a study published by the Conference Board on Tax Allocations.20/ The study is based on experience under Section 482 by over 500 companies involving foreign affiliates and Western Hemisphere trade corporations. It was based on examinations conducted by the Internal Revenue Service involving such companies.

The following pricing adjustments were proposed:

(1)	Comparable Uncontrolled Price Method	28%
(2)	Resale Price Method	23%
(3)	Cost Plus	36%
(4)	Other	36%

It is noted only a small percentage of cases were settled on the comparable uncontrolled price method. The reason being the difficulty in obtaining comparable products sold in similar circumstances, differing conditions, and services or intangibles which may be furnished to affiliates.

There are similar problems with respect to the resale price method. Again there is a lack of comparable data. The Source Book of Statistics is unreliable because of the variables, and, even when used, parties generally look to pre-tax profit in the allocation of income. It was noted that most settlements were simply based on arbitrary percentages.

The cost plus method fared no better. It is frequently used for determining prices on sales to Western Hemisphere trade corporations. But again the problem is to determine the appropriate markup.

19/Business Europe Vol. XVI, No. 25 JA-76 (June 18, 1976)

20/"Developments in Intercompany Pricing Under Section 482" Seventh Annual Institute on International Taxation 103 (July 16, 1976)

The fourth method was used as much as any method and was obviously used far more than any method for settlement purposes.

Under the last method, a wide variety was used from:

(1) Allocation of entire net income.
(2) Allocations based on elaborate computations.
(3) Split of gross profit.
(4) Split of total pre-tax profits based on formula, such as using assets, sales.

It seems clear that the Internal Revenue Service uses some sort of formula apportionment with respect to Section 482 adjustments and settlements far more than any other method. Obviously, it would be far easier for it to admininter Section 482 if the Internal Revenue Service was mandated to apply a reasonable apportionment with respect to intercompany transactions involving foreign and domestic affiliates. In addition, taxpayers could determine their tax liabilities with a high degree of accuracy, with reasonable assurance they would not incur substantial deficiency assessments or protracted and expensive litigation.

In our view there is no reason why a fictitious arm's-length standard as demonstrated should be mandated on the states since they have developed a far more reliable method for determining the income of a unitary business.

E. If tax preferences did not exist it would seldom be necessary to apply an arm's-length standard because management control accounting would usually coincide with tax accounting principles. The facts, however, are that tax rates are different in many states. In some cases corporate income taxes are not imposed, and, even when corporate taxes are imposed different kinds of income are treated differently. The most frequent difference being in the state treatment of investment income, which may be exempt from tax or taxed only nominally. At a national level, again tax rates vary, as do the effective rates for various kinds of income, e.g., royalties, dividends. Furthermore, because foreign taxes are generally allowable as a credit whereas state taxes are only deductible, it is frequently advantageous to attribute income to a foreign country where a credit is allowed, instead of to a state where only a tax deduction is authorized.

An arm's-length concept presupposes tax laws are neutral, i.e., taxpayers are indifferent as to where in the unitary business process income is realized. For example, if a vertically integrated company mined, refined, fabricated, and sold aluminum products, would it be reasonable to assume that the company is indifferent as to whether more income is attributable to the mining operations than other activities, when its 14% or 22%

(for U.S. deposits) depletion allowance is based on "gross income from the property" including mining, sorting, concentrating, sintering, and substantially equivalent processes to bring to shipping grade and form, and loading for shipment?21/

The remarks made in a speech by Assistant Secretary of the Treasury Stanley S. Surrey in discussing Section 482 of the Internal Revenue Code with respect to foreign country taxes in 1967 are even more appropriate today than when delivered. Secretary Surrey commented:

> The salient fact is that a taxpayer worry about the section (482) is almost a symbol of status, for a Section 482 worry is generally the price of possessing a tax preference.

He also noted that:

> Private research studies show that some major companies even have one set of allocations to permit management control of their international business, but another set of allocations to squeeze the tax benefits from preferences.22/

A combined report eliminates the disadvantages of Section 482 because it becomes unnecessary to determine the separate gross income and deductions which a particular corporation in a commonly controlled group earned and incurred since each segment in a unitary business is deemed to have shared in the earning of the entire unitary net income. Therefore, a taxpayer does not have the ability to manipulate its income nor to divert profits from one segment to another segment of the multinational business and thus from one country to another.

F. An arm's-length determination assumes that the sales price for the same product is uniform. Certainly, as production is increased the cost per unit is reduced. Furthermore, the efficiencies and economies vary so that an integrated company, if it desires, can allocate overhead or other charges to different operations, thereby affecting the profitability even though its ultimate sales price is the same as that of its competitors. In such cases, under separate accounting it would be quite easy to divert most or all of the profits to the taxing jurisdiction with the lowest rate.

21/ Internal Revenue Code § 613(c)(4)(C)

22/ Address to the National Foreign Trade Council Convention 1967

The unreliability of separate accounting was recently demonstrated by a prepared statement of W. T. Slick, Jr., Senior Vice President, Exxon Co., U.S.A., in discussing rate of return.

> Well accepted variations in accounting practices and financing policies result in significant variations in rate of return by any of several definitions. Also, profitability of an individual corporation examined in isolation is meaningless. In any industry, some firms will perform better than average due to greater efficiency, skill in meeting consumer demand, or other unique factors, while other firms perform less well.23/

The interdependence and the unitary nature of petroleum operations are summarized as follows:

> Some degree of vertical integration must be recognized as a natural economic structure in petroleum operations which consist of a continuous flow of product from the wellhead to the ultimate consumer. Not only the large companies, but numerous other ones have adopted this structure (e.g., Diamond Shamrock Corporation; Charter Company; Murphy Oil Corporation; Tesoro Petroleum Corporation; Apco Corporation and Pasco, Inc.). Vertical integration is common in other industries as well, including aluminum, steel, food processing, and newspapers to cite a few. This is so because vertical integration is an efficient form of organization. It allows improved coordination, planning and communication among the various segments and thus reduces risk and uncertainty. It allows fuller utilization of capacity and minimizes the impact of unforeseen contingencies on operations. This in turn results in lower costs and greater assurance of product quality and availability to consumers.24/

23/ Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, United States Senate, 94th Congress, 1st Session, Hearing on S. 1176, Part 9, The Energy Industry, p. 448

24/ See 23 supra at 466

G. The unreliability of accounting records is clearly demonstrated in the case of the multinational corporation and technology transfer.

Many multinational corporations will point out that formula apportionment may cause an unfair apportionment of income because labor in the United States exceeds the labor costs in other countries. In many cases this is not true, but even when this is, the productivity in the higher wage country may greatly offset the wage differential. The productivity can be attributed to any number of factors, e.g., training, technology, inherent skill, climate, etc. The double-barreled effect of technology transfer, and the basic unitary nature of such transfer is demonstrated by a study by J. Baranson of Cummings Diesel.25/ Mr. Baranson's study showed Cummings encountered high production costs for individual, finished machines in a less-developed country. The higher rate of rejection was because of inexperienced workers, the less precise work by men where machines were normally used in the developed country, and the workers' less disciplined attitude toward working with machines all contributed to higher costs. The finished product cost more than the same engine imported.

When the conditions and motivations enable the multinational firm to modify its technology for the lesser developed country market, it may find itself in the unique position of being able to incorporate design parameters drawn from the developing countries in its products for other markets. Baranson reported that Cummings Diesel had been able to adapt their engine designed specifically for Indian production to several other uses. In the United States, it serves as a stop-and-go urban delivery truck engine; in South America, it powers a line of small trucks; and at the time, it was being considered for a new line of economy cars in Britain.

With respect to the transfer of technology, a company is in a unique position since it may create a subsidiary, enter into a joint venture, or license the use of its know-how. The method the company chooses to use can have great federal impact, since in many cases the research and development expenses have long since been charged against U.S. income. In many cases, only the more obsolete technology is transferred while the new research expenses continue to reduce income taxes. When the income is repatriated, a federal tax credit is allowed. If a repatriation can be deferred for a number of years, the tax benefit is even greater.

25/Rive, "The Multinational Corporation in the LDC: Is There Room for a Broker," Management of the Multinationals Free Press 1974, p. 41

Of equal significance is the fact that the unitary concept does not create taxable income on the basis of intercompany transfers. This is the correct result, since such sales do not affect the realized income until the products are sold to unrelated parties. Moreover, a tax would not be imposed on a single corporation, which is a component of a unitary business, unless the unitary business is operated at a profit.

Some of the difficulties of Section 482 were officially recognized in a report dated March 8, 1977, prepared for the Committee on Ways and Means, U.S. House of Representatives, for a Task Force study on foreign source income. The report states:

> This approach (sec. 482) already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to interstate transactions. Thus, there is no significant disagreement that the states must use some type of an apportionment formula (as distinguished from separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries). 26/

26/ "Recommendation of the Task Force on Foreign Source Income." Committee on Ways and Means, U.S. House of Representatives, March 8, 1977, p.28

ATTACHMENT 4

SUMMARY OF CALIFORNIA CORPORATE TAX LAW AND FEDERAL LEGISLATION, BILLS, HEARINGS AND REPORTS RELATING TO STATE TAXES ON CORPORATE INCOME

Background

The California tax on corporations was enacted in 1929. This tax is imposed only upon corporations which engage in intrastate business in California. In order to complement the franchise tax, the Legislature enacted the corporate income tax in 1937. This tax applies principally to corporations engaged in interstate activities and deriving income from sources within this state. The validity of the tax was sustained in 1946 (West Publishing Co. v. McColgan, 27 Cal.2d 705, affirmed 328 U.S. 823).

In 1959, in the Northwestern Portland Cement and Stockham Valves cases, 358 U.S. 459, the Supreme Court ruled that regular and substantial solicitation of sales in a state would subject a corporation to tax and make it liable for a fairly apportioned state net income tax, notwithstanding that all of its transactions were in interstate commerce. Although the California taxing agencies felt the decisions only reaffirmed the 1946 West Publishing case, supra, the national business community treated the cases as a radical departure from existing law and at their insistence, in response to the Northwestern - Stockham cases, Congress almost immediately enacted P.L. 86-272.

Public Law 86-272

In enacting Public Law 86-272, on September 15, 1959, Congress, for the first time directly prohibited state income taxation with respect to certain activities. P.L. 86-272, in general, provides that a business is exempt from income taxes if it only solicits sales of tangible personal property, the orders for which are filled from outside the state.

The Act also directed the House Committee on the Judiciary and the Senate Committee on Finance to study all matters relating to state taxation of interstate business activities. This responsibility was discharged by the issuance in September 1965 of Volume IV of the Report of the Special Subcommittee on State Taxation of Interstate Commerce of the House Judiciary Committee, 89th Congress, 1st Session, House Report No. 952. It included the recommendations of the Subcommittee, which were endorsed by the full Committee. On October 22, 1965, Representative Willis, Chairman of the Subcommittee, introduced H.R. 11798, to carry out those recommendations.

FEDERAL LEGISLATION, HEARINGS AND REPORTS

H.R. 11798 (1965)

This bill was a comprehensive tax act which would have largely replaced state corporate income and sales and use tax laws with federal rules and administration. Briefly, the bill specified a jurisdictional standard for the imposition of taxes above the existing level; required income to be apportioned by a formula which would have shifted the tax burden onto California based businesses; required all states imposing an income tax to use federal tax base as a starting point, but within "certain limits" state adjustments could be made; provided that the Internal Revenue Service would (1) issue rules and regulations on the apportionment of income; (2) have the power to modify the apportionment formula to avoid unfairness; (3) establish the procedure for reviewing multistate disputes on the administrative level; and (4) study interstate tax problems the Subcommittee didn't explore fully. Disputes would have been resolved by the federal courts.

The bill would have severely limited California's taxing jurisdiction, greatly restricted the Legislature as to the establishment of the corporate tax base, and substituted the Internal Revenue Service for state tax administration and federal for state courts with respect to all but one-third of the California corporate income taxes.

Hearings were held on January 26-28; February 2, 4, 9, 10, 17, 18, 24, 25; March 2-4, 16-18, 23-25, 30, 31; April 1, 5, 6, 1966. See Committee Reports of the Hearings.

H.R. 16491 (1966)

Because of widespread opposition, a somewhat milder bill was proposed. This bill was H.R. 16491, introduced on July 25, 1966. This new Willis Bill eliminated those provisions which provided for direct federal administration of state and local taxes. It also no longer compelled states to use a moving federal tax base for corporation income tax purposes. The bill's two-factor apportionment formula was limited to multistate businesses whose average net income over a 5-year period was $1 million or less. Businesses also had the option of determining income under state apportionment formulas. This bill was not voted out of the House Rules Committee.

H.R. 2158 (1967)

In the 90th Congress H.R. 2158 was introduced by Congressman Rodino. It was identical to H.R. 16491 and passed the House with minor amendments by a vote of 289 for and 84 against. No further action was taken.

H.R. 7906 (1969)

This bill, also by Congressman Rodino, was introduced during the 91st Congress on June 30, 1969. It was identical to H.R. 2158, as amended. It passed the House by a vote of 311 to 87, with California congressmen voting against the bill 21 to 15. No further action was taken.

Ribicoff Proposal

Previously at the close of the 90th Congress Senator Ribicoff (Conn.) inserted in the Congressional Record a draft of a bill he intended to introduce in the 91st Congress and called for its early consideration. This bill differed from the House bills in that the $1 million limitation was eliminated and states would be precluded from requiring a corporation to combine or consolidate its income with any corporation which did not have a business location in the state.

In his remarks offered in support of the legislation Senator Ribicoff stated in part:1/

> The second major amendment contained in the draft relates to what is the so called unitary business concept2/ of applying state income taxes. This practice requires a company within the taxing jurisdiction of a state to include in the measure of its tax income from an affiliate which is not itself subject to the jurisdiction of the taxing state. The unitary business concept has been used extensively by the State of California and, in fact, has become commonly known as the California practice.

1/ Congressional Record - Senate, October 28, 1968, p. E9480.

2/ The unitary income as defined by John Deere Plow Co. v. Franchise Tax Board, 38 Cal.2d 214 at 223 is (that) derived from the functioning of the business as a whole, to which the activities in the various states contribute; and that by reason of such interrelated activities in the integrated overall enterprise, the business done within the state is not truly separate and distinct from the business done without the state so as reasonably to permit of a segregation of income under the separate accounting method rather than use of formula method in assigning to the taxing state its fair share of taxable values.

S. 916 (1969)

On February 4, 1969, during the 91st Congress, Senator Ribicoff introduced S. 916, which contained the provisions mentioned in the draft bill and repeated his earlier statements with respect to the unitary concept.[3]

1971 Bills

A number of bills regarding interstate taxes were introduced during the 92nd Congress. None were set for hearing, undoubtedly pending Senate action. The principal bills introduced in this Congress were:

H.R. 1538, 2536, 4770. Same as H.R. 2158, the Special Subcommittee staff bill.

H.R. 4267 and S. 1210. Covered only sales and use taxes.

S. 317. Similar to H.R. 1538, except generally precludes use of combined reports or consolidated returns.

S. 1883. Would give consent to Multistate Tax Compact; requires all states to use the Uniform Act for the apportionment of income.

S. 3333. Comprehensive bill - income tax provisions based on H.R. 11798 (1965), sales and use tax provisions similar to H.R. 4267 and S. 1210.

S. 4080. Drafted over a period of months with help of National Association of Manufactureres, Counsel of State Chambers of Commerce, National Association of Wholesalers. Would prohibit continuation of many California tax practices.

H.R. 6160. Consents to Multistate Tax Compact.

1973 Bills

The principal bills are:

H.R. 977, same as 1538, 2536, 4770 (1971). Special Subcommittee staff bill.

H.R. 6822, Common Tax Audit Act.

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[3] Congressional Record - Senate, February 4, 1969, p. 1231.

S. 282 and H.R. 1453, similar to S. 1210 and H.R. 4267 (1971) - covers only sales and use taxes.

S. 1245, similar to S. 4080 (1971).

S. 2092, similar to S. 1883 (1972).

S. 2811, relates to procedure for collecting sales and use tax on interstate sales (introduced by Senator Mondale after hearings).

Senate Hearings

On September 18-19, 1973, a Subcommittee of State Taxation of Interstate Commerce of the Senate Finance Committee conducted hearings. No report was issued.

1975 Bills and Study

H.R. 9 (Rodino), same as H.R. 977, 93rd Congress.

S. 2080 (Mathias), revision of S. 2811, 93rd Congress.

Public Law 93-100 Study. Study conducted by the Advisory Commission on Intergovernmental Relations related to state doing business taxes on out-of-state depositories. For Reports see State and Local Taxation of Banks, Senate Committee on Banking, Housing and Urban Affairs, dated December 1971, and State and Local "Doing Business" Taxes on Out-of-State Financial Depositories (94th Cong.) May 1975 (supplemented, September 1975).

1976 Bills

Committee on Ways and Means. Recommendations of the Task Force on Foreign Source Income. During consideration of the Tax Reduction Act of 1975 (P.L. 94-12). Congressman Jones proposed at a hearing where only members could participate that states be required to follow the income source rules of the Internal Revenue Code (Sections 861-863). The proposal was referred to the Task Force for consideration.

On March 24, 1976, representatives from California and Oregon, together with Professor Hellerstein and Paul Dillingham from Coca Cola corporation participated in a panel discussion before the members of the Task Force. A Committee Report was released on March 8, 1977.

The Committee Report stated at page 28:

> This approach (arm's length [added]) already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to the interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries).

1977 Bills (as of April, 1977)

H.R. 669 (Rodino), see H.R. 9, 1975.

H.R. 1832 (LaFalce) to extend the bank tax moratorium to January 1, 1979.

Senator CHURCH. A question that comes up is that that takes us further into the business of determining State tax policy. I think that cannot be denied. Where it leads us is a very important consideration. Now, Mr. Gallagher.

STATEMENT OF STERLING GALLAGHER, COMMISSIONER, DEPARTMENT OF REVENUE, STATE OF ALASKA, JUNEAU, ALASKA

Mr. GALLAGHER. I am Sterling Gallagher, commissioner of revenue for the State of Alaska, and treasurer for the Multistate Tax Commission.

The State's main objection to article 9, paragraph 4, of this treaty is that what this treaty acocmplishes is to knock out the unitary method of taxation which we think is a very fair method of taxation. It actually sets up a uniform method by which corporations will be taxed. It combines them in a total and enables us to deduce what is taxable income in various States. We think this method accurately reports income in the various States. You can either go the unitary method and go with the formula approach or you can try to go with what the United States just announced in the last few weeks, that they are attempting to do with Canada, have some kind of joint reporting system or joint audit system. That system also can be very effective. Since there are many nations in the world it will be a very difficult task for all these countries to get together to do a joint audit. That may be the only way that this Nation can get to the true income of the corporations.

The unitary method prevents tax avoidance. Between affiliated corporations there are many management fees that go back and forth. There is artificial pricing of goods. These are all tax avoidance areas.

I depart quite a bit from my testimony and describe to you a transaction by a corporation in Alaska that is a foreign-owned corporation, not a British corporation. It has been in existence in Alaska for over 30 years. It has not paid 1 cent of income tax to this Nation or to the State. The reason is artificial pricing between nations. They made a filing before—I am also the chairman of one of the industrial development boards--they made a filing before our board that showed a negative net worth, and that is a corporation of $27 million. Yet they had borrowed from their home country $40 million.

So I at least estimate there was $27 million of capital escorted overseas that was never taxed by either this Nation or the State. Right now the IRS has over a $40 million case against that corporation. It has been going on for 10 years. There has been nothing accomplished yet. What I am trying to say is maybe section 482 is the problem. This arm's length transaction is totally ineffective. This treaty here will cost the State of Alaska in 1980 around $50 million.

RECOMMENDATIONS

In summary, as a State I would like to recommend that you protocol out article 9, paragraph 4 of this treaty and as a further step, as a citizen of the United States, I would ask the Congress to investigate the whole workings of section 482 of the Internal Revenue Code.

Senator JAVITS. I did not get your last point. You want the Congress to investigate what?

Mr. GALLAGHER. How section 482 of the Internal Revenue Code is being used between nations.

Senator CHURCH. I might say that the Subcommittee on Multinational Corporation which I chaired for 4 years did look into this question. There is no doubt but what large multinational corporations through their ability to transfer not only capital but also their pricing policy between parent companies and subsidiary companies, make it exceedingly difficult to determine what the proper tax should be which results in an enormous advantage over other smaller businesses. I know that the unitary tax is an attempt to deal with that problem.

Whether or not this is the way to deal with the problem I can't say. But we should decide first by dealing with the treaty with England. Alaska can't make that decision. It is a very important British problem because we will soon be asked to do that in connection with German business and French business and Japanese business. Having done that I am sure other State taxes will be troublesome with which the treaty might become the most convenient means to deal. I want this committee to know an important precedent is being established here, and there is reason for the strong resistance to doing it on the part of the United States.

[Mr. Gallagher's prepared statement follows:]

PREPARED STATEMENT OF STERLING GALLAGHER, COMMISSIONER OF REVENUE STATE OF ALASKA

Chairman Sparkman and members of the Senate Foreign Relations Committee: For the record I am Sterling Gallagher, Commissioner of Revenue for the State of Alaska and Treasurer for the Multistate Tax Commission.

I am here today to express the opposition of the State of Alaska to the United States and United Kingdom Amended Income Tax Treaty. Under its power set forth in Article II, Section 2 of the U.S. Constitution I strongly urge that the Senate not ratify this income tax treaty or a the very least reserve those provisions of the convention which are most offensive.

While convincing arguments can be made against the U.K. Treaty for reasons that it places United Kingdom companies in a preferred position relative to companies located in other countries and that it sets a dangerous vehicle for limiting the taxing powers of the states since it was conceived without public hearing and without input from the states, I will limit my comments to the compliance and revenue implications of the treaty.

The main objection of Alaska and other states lie with Article 9, paragraph 4 of the treaty which prevents the unitary method for determining net income and the use of the combined report for corporations affiliated with United Kingdom companies. This prohibition would destroy the most effective tool which the states have in combating the multi-jurisdictional tax avoidance schemes available to multinational companies.

For many reasons, a business is not always conducted in one geographic area or in the form of one corporate entity. Especially in the case of very large companies operating on a global basis, literally hundreds of corporations or branches may be formed to carry on the activities of what, in reality, is one, unified, controlled business. Accordingly, under the unitary method as used by Alaska and other states the combined net income of the entire economic unit of corporate business is aggregated and inter-company transactions are eliminated. This combined net income is then apportioned to the states using a three factor formula comprised of sales, payroll and property for the purpose of determining the extent of the combined group's business activity in a particular jurisdiction and hence the portion or percentage share of the total group's net income attributable to the group's activity in that jurisdiction. This method has at least two advantages. First, it more accurately represents the economic

reality of the way that large modern businesses, especially large multinational corporations, operate. In real terms a unitary enterprise is operated as a unit with the net income being earned by the entire operation as a whole rather than by each segment of the business. The net profit is actually the final result of the continuous series of income and expense transactions among the various component parts of the business. The unitary method recognizes this economic reality and uses it as a basis for taxation.

Secondly, the use of the unitary method forestalls the tax avoidance possibilities of profit shifting among several globally affiliated corporations. This shifting of profits is accomplished by artificially pricing the sale of goods, the use of "management fee" charges between corporate subsidiaries. For example, when goods are transferred from one division or affiliate to another, the amount charged to each segment of the business can be essentially anything that the enterprise finds in its best interest to charge. Likewise as an affiliate or another division provides management, accounting, legal or other related services for another affiliate or division, the same flexibility exists for determining the amount of fees to be charged. In this manner income and expense can be effectively shifted from one part of the total unitary business to another.

By using the unitary approach you do not have the profit shifting problems such as artificial pricing of sales between related corporations or the charging of management services since all income is combined and intercompany transactions are eliminated.

The only provision in the treaty for dealing with tax avoidance schemes is the "arms-length transaction" method set out in paragraphs 1 and 2 of Article 9. This is essentially the method prescribed in Section 482 of the Internal Revenue Code and has been demonstrated to be extremely ineffective. Under this method, if taxpayers belong to a related group in which the members transact business between each other, it is presumed that the transactions are carried on at an "arms-length" basis or a fair market price that would be available to any non-related party. Like Section 482, the treaty method would allow the states to make adjustments to the companies income and expense if it appears that such transatcions were not conducted on an "arms-length" basis. This process is a factual nightmare. In order to establish that a transaction was not made on an "arms-length" basis, facts must be gathered to determine what an "arms-length" price might have been under the circumstances. Often it is difficult to find a similar transaction in order to verify an "arms-length" price. The practical result may be a compromise between the taxpayer and the taxing authority over what the fair market value of the transaction should have been. If no agreement can be reached, then each side must present its facts to a court and the court must decide what the fair market price should have been. I am aware of one such Section 482 case in Alaska that the IRS has been working on for several years and which has not yet been resolved simply because there is no comparable market for the product and there is therefore no third party verification available. This method essentially becomes a tangled battle of the experts to determine whether inter-company transactions were properly reported and whether they took place at a fair market "arms-length" basis.

The same sort of multinational tax avoidance games that the states are trying to avoid are actually sanctioned at the federal level. For example under current federal tax laws, if a multinational corporation is incurring expenses or losses overseas it may operate as a single corporation and take the expenses or losses as a part of its entire business operation. This reduces the corporation's taxable income. After the overseas operation becomes profitable, the corporation may then separately incorporate the overseas operation. Any forced payment required by a foreign government can then be requested to be structured in the form of income taxes rather than as royalties or other payments. These "taxes" paid to the foreign government become credits against the United States tax liability, thus reducing the tax revenues of the United States. Although the United States may desire to allow this sort of multinational tax avoidance as part of its tax policy, it should not be imposed on the states. Instead, we believe that the efforts of the Treasury Department might be better spent ferreting out these international tax avoidance schemes and proposing tax reform measures rather than imposing the same revenue draining system on the states. This revenue drain on the federal treasury is amply illustrated in the Fifth Annual Corporate Tax Study presented by Representative Vanik. That report shows

that the large multinational corporations pay only a modest effective tax rate on their world wide income, substantially below the statutory rate of 48 percent. This is due in large part to multi-jurisdictional tax avoidance.

Because of the potential tax avoidance possibilities, this treaty poses a substantial threat to the functioning of Alaska's fledgling corporate income tax program and its revenues. Alaska's economy focuses around its varied natural resources such as timber, fisheries, minerals and oil and gas. Major portions of these resources are developed by corporations controlled or affiliated with corporations in foreign companies. It is essential to an equitable tax system that these foreign based industries not escape taxation on their activities in the state through tax loopholes and that they pay their fair share of corporate income tax. If this treaty is ratified, Alaska will lose the single most important imprement used in plugging the international tax avoidance games—the unitary concept.

As shown earlier these schemes can result in corporations avoiding all state income taxation. Of special concern to Alaska is that the treaty restrictions would have an immediate effect on our ability to tax one of the largest oil companies involved in North Slope oil production. Without the ability to determine the net income of the total organization, this multinational oil company could by its pricing structure and management fee arrangements between its own companies, avoid paying any income tax to our state. The impact of this objectionable treaty, however, is not limited to just this one corporation but applies to other oil corporations as well as corporations in other industries.

While confidentiality statutes prevent identification of particular companies, our estimates shows that oil industry companies would pay approximately $50 million dollars less annually in taxes to the State of Alaska if the UK Treaty were adopted. If other industries were examined the picture could be even worse.

Accordingly, I respectfully urge that the Senate not give its consent to the United States-United Kingdom Tax Treaty. In any event I would strongly suggest that Article 9 paragraph 4 of the Treaty be reserved as an unwarranted and ill advised restriction of the states.

Thank you.

Senator CHURCH. Our last panelist is Theodore W. de Looze of the Oregon Department of Justice.

STATEMENT OF THEODORE W. DE LOOZE, CHIEF TAX COUNSEL, OREGON DEPARTMENT OF JUSTICE, SALEM, OREG.

Mr. DE LOOZE. Mr. Chairman and members of the committee.

Senator CHURCH. May I explain the light system. It is like the traffic light system. Under the 10-minute rule the green light means you have time remaining, the amber light is the warning signal you are about to expire. The red light signifies termination.

Mr. DE LOOZE. After hearing some of the testimony this morning I do not need the red light. I am about to expire. But I would like to state on behalf of the State of Oregon that our paper summarizes and reinforces all of the positions that have been taken by the State of Alaska and the State of California, and I am not going to belabor the point. I would like to make certain specific observations in the course of my testimony and let it go at that. First of all I would like to put into the record several resolutions of the Multistate Tax Commission and I believe they are unanimous resolutions; one in 1976 opposing Federal restrictions on State taxing powers and methods, whether by the treaty method or by congressional enactment. The second is the 1977 resolution which was unanimous, that the Multistate Tax Commission endorses the unitary concept by its members and also the use

of worldwide apportionment, unitary concept on a worldwide basis.

[The information referred to follows:]

MULTISTATE TAX COMMISSION

RESOLUTION NO. 2—OPPOSING FEDERAL RESTRICTIONS ON STATE TAXING POWERS AND METHODS

Whereas, both the Executive and Legislative Branches of the Federal Government have under consideration separate proposals which would override state taxing powers and methods; and

Whereas, the Executive Branch has secretly negotiated a treaty with the United Kingdom, without consulting any state, although the pending treaty for the first time in the nation's history contains provisions restricting state income taxes, and reduces state income tax revenue for the benefit only of multinational corporations, the principal beneficiaries being the worldwide major oil corporations; and

Whereas, the United States House Ways and Means Task Force on Foreign Source Income has under consideration a proposal by Representative Jones to limit states in determining the amount of income derived from state sources to the federal tax base, thereby permitting multinational corporations to manipulate their income by the corporate form through which their activities are conducted, and the geographical areas to which sales are attributed; now, therefore, be it

Resolved by the Multistate Tax Commission as follows:

1. That it opposes the unprecedented action adopted by the Executive Branch in proposing to secretly bargain away the states' taxing powers, and in particular because such action benefits only the world's largest taxpayers which have never demonstrated that they are exposed to tax on all of their income.

2. That the Multistate Tax Commission continue to oppose any restrictive federal tax legislation with respect to multistate or multinational taxpayers.

3. That each member and associate member state of this Commission request their state legislatures to enact appropriate Resolutions urging that the treaty provisions relating to state taxes be reserved, and that Congress not approve any restrictive federal interstate tax legislation.

4. That copies of the Resolution be sent to: (a) The President of the United States; (b) United States State Department; (c) The Treasury Department, International Tax Section; (d) The Senate Committee on Foreign Relations; (e) The House Committee on Ways and Means; (f) The Senate Finance Committee; (g) The Joint Committee on Internal Revenue Taxation; and (h) The House of Representatives Ways and Means Task Force on Foreign Source Income.

5. That the Executive Director be directed to attend all public hearings regarding the pending treaty and the task force proposal and urge that the parts of the treaty relating to state taxes be reserved, and that any task force proposal to limit taxes or taxing methods as to multinationals be rejected.

RESOLUTION NO. 3

Be it *Resolved*, that:

(1) It is the official policy of the Multistate Tax Commission that the unitary business concept is appropriate for attributing income with respect to all businesses affected by the Uniform Division of Income for Tax Purposes Act; and that

(2) It is appropriate on a worldwide as well as a domestic basis regardless of whether the parent or some or all of the subsidiaries are located outside or inside the United States; and that

(3 The Commission recommends that each state pursue the policy recommended in this resolution to the full extent permitted by its laws; and that

(4) Where a state's laws do not permit complying with this recommendation, efforts be made to amend those laws in order to effect such a result.

QUESTION BEFORE COMMITTEE

Mr. DE LOOZE. I think it is important for this committee to know that connected with the unitary concept is the idea of determining where income is located. Connected with it is the concept of multistate audits which the multistate commission is pursuing; and connected with the idea is much more than simply overseas operations. Now I think the question for this committee comes down to whether or not this provision in article 9 is really necessary for this treaty. Are you willing to say that the States, which are, of course, not separate sovereignties, but do represent you and you represent them—are you willing to make the States pay the price that comes along with this treaty precedent?

As you have said, Mr. Chairman, it is not just a matter of this treaty, it is a matter of other treaties that will include his provision we object to. However, it goes beyond that. Mr. Woodworth stated that technically and legally a State could continue to combine domestic corporations even though this and similar treaties might be enacted. But that is not the whole story. Certainly this treaty creates discrimination. That discrimination will affect domestic combinations. There is no question in my mind or in any of the states that operate under the unitary concept that politically and pressurewise the argument of discrimination will be made to throw out the use of the unitary concept in domestic combinations. The treaty is the cornerstone or the keystone of the whole unitary concept, which you are considering today.

Are you willing to kick out that cornerstone and have the whole arch collapse on the whole unitary concept? That is the price you are asking us to pay.

In addition, Mr. Woodworth has stated as precedent for this treaty that there are some 25 treaties that the U.S. has already entered into which preclude the states from discrimination. You, in effect, are considering a treaty provision that is in contradiction and contravention of those other treaties, because you are creating discrimination by this treaty.

EXTENT OF UNITARY CONCEPT

Just a word about the extent of the unitary concept and what States are utilizing this. Mr. Cory has stated that 31 States use it. It must be understood by this committee that use of the unitary concep is a growing process. The States have been in a broom closet for all practical purposes for many years, and they are coming out of that closet and realizing that income has not been reported to them, and they have to do something about it. The Multistate Tax Commission is a part of that process. Use of the unitary concept, together with multistate audits, is a growing trend to discover unreported income.

The most recent case on the unitary concept was decided July 11, 1977, in the State of Montana. I would like to put into the record if you please the decision of that court.

Senator CHURCH. Very well.

[The information referred to follows:]

[No. 13249; in the Supreme Court of the State of Montana; 1977]

MONTANA DEPARTMENT OF REVENUE, STATE OF MONTANA, PETITIONER AND APPELLANT,

vs.

THE AMERICAN SMELTING AND REFINING CO., DEFENDANT AND RESPONDENT

Appeal from: District Court of the First Judicial District, Honorable Peter Meloy, Judge presiding.

Counsel of Record:

For Appellant: Terry B. Cosgrove argued, Helena, Montana; Theodore W. DeLooze argued, Salem, Oregon.

For Respondent: Hughes, Bennett and Cain, Helena, Montana; George T. Bennett argued, Helena, Montana; Charles Smith, Helena, Montana.

For Amicus Curiae: William D. Dexter appeared, Olympia, Washington.

Submitted: January 27, 1977.

Decided: July 11, 1977.

Filed: July 12, 1977.

THOMAS J. KEARNEY,
Clerk.

Mr. Chief Justice Paul G. Hatfield delivered the Opinion of the Court.

This is an appeal by the Montana Department of Revenue (DOR) from a judgement entered in the district court, Lewis and Clark County, affirming a final decision of the State Tax Appeal Board (STAB). The STAB decision ordered a recomputation of the deficiency assessment levied by DOR against American Smelting and Refining Company (ASARCO).

In 1972 the auditors of the Multistate Tax Commission conducted an audit of ASARCO's records for the tax years 1967–1970. Subsequent to this audit, additional corporation license taxes were assessed against ASARCO by DOR. The amount of this deficiency assessment is the underlying issue upon repeal.

ASARCO is a New Jersey corporation engaged in national and inter-national operations in the business of mining, smelting, refining, manufacturing, buying and selling nonferrous metals and minerals. ASARCO basically engages in two separate, but related areas of operation. The first is a primary metal operation consisting of mining, milling, smelting and refining of nonferrous metals. The second is a nonferrous alloy operation consisting of the manufacture and sale of alloy products.

For the tax years in question ASARCO owned mines in Colorado, Washington, Arizona, New Mexico and Idaho in addition to mines in Canada and other foreign countries. It operated smelters and refineries in Texas, Maryland, Colorado, Montana, Missouri, Arizona, Nebraska, New Jersey, Washington and California for the years in question. Alloy manufacturing plants were located in Texas, New Jersey, California, Oklahoma and Indiana. ASARCO sales offices were located in New York, Baltimore, Boston, Cincinnati, Cleveland, Detroit, Milwaukee, Philadelphia, Rochester and St. Louis.

ASARCO owns and operates a smelter in East Helena which is its principal operation in Montana. This smelter receives lead ores and concentrates from company mines as well as unrelated suppliers. The smelted, but unrefined lead product is then shipped to other units of ASARCO for further treatment and eventual sale. Anaconda Company purchased various by-products of the East Helena smelter for the years in question. In addition to the East Helena smelter ASARCO owns certain active and inactive mining properties in Montana.

Prior to 1962 ASARCO reported its income from its Montana properties by separate accounting, pursuant to section 84–1503, R.C.M. 1947. Under that method ASARCO determined the gross receipts from its Montana properties and deducted all expenses incurred by or attributable to such as the cost of transportation were attributable to more than one state, they were apportioned to determine the Montana portion.

In 1962 ASARCO recognized that its business was unitary in nature and it could no longer use separate accounting for its income. Pursuant to section 84–1503 it requested permission from DOR to change from separate accounting to the unitary method of accounting. Permission was granted by DOR and a "hybrid" system of reporting income was instituted. Under this hybrid system,

all but a negligible amount of total company income from rents, royalties, dividends, interest and sales of tangible and intangible properties was allocated to sources outside Montana. After deductions for the allocated income, ASARCO's operating net income was apportioned to Montana sources by the use of a three factor formula.

An in-depth examination of ASARCO's hybrid system indicates the following procedure was used to compute tax liability for the years in question. ASARCO classified the income listed below as nonbusiness income under DOR's 1967 regulations, deducted it from its apportionable income, and allocated it as indicated:

(a) Income from mine royalties paid by the lessees of ASARCO's Keystone Mine previously operated by ASARCO and located in the State of Colorado was allocated to the State of Colorado;

(b) Income from patents and copyrights on items developed by ASARCO's research department and used in ASARCO's operations and licensed to others, was allocated to commercial domicile;

(c) Income from rental of housing units on mining properties and rented to employes was allocated to the state where such rental units are located:

(d) Interest income from United States obligations, customers notes and bonds, notes on the sale of a plant and General Cable stock, from state and municipal bonds, time certificates, bankers acceptances, and commercial paper was allocated to the state of commercial domicile;

(e) Gains from the sales of tangible properties were allocated to the state of sale;

(f) Dividends paid on stocks were allocated to state of commercial domicile;

(g) Gains from the sale of stock were allocated to the state of commercial domicile; and

(h) Income from securities deposited with Montana state agencies and from money deposited in Montana was allocated to Montana.

The percentage of apportionable income or loss attributable to Montana sources was calculated by the use of this formula:

$$\frac{\frac{\text{Montana property}}{\text{Total ASARCO property}} + \frac{\text{Montana payroll}}{\text{Total ASARCO payroll}} + \frac{\text{Montana Sales}}{\text{Total ASARCO sales}}}{\text{Averaged by dividing by 3}} = \text{—}\%$$

The percentage obtained was then multiplied by ASARCO's total apportionable income to determine the Montana contribution.

DOR contends the hybrid system used by ASARCO to calculate its Montana income incorrectly interpreted section 84–1503, R.C.M. 1947. That section at the time in question, stated:

"If the income of any corporation from sources within the state cannot be properly segregated from income without the state, then, in that event, the amount of the net income returned shall be that proportion of the taxpayer's total net income which the taxpayer's gross business done in the state of Montana bears to the total gross business of the taxpayer, and apportionment shall be made under the rules and regulations prescribed by the state board of equalization, giving consideration to sales, property and payroll and such other factors as may be deemed applicable; provided, however, that the sttae board of equalization shall, upon the presentation of satisfactory evidence, determine that the income from sources within the state of Montana may be properly segregated from income from sources without the state of Montana and shall allow separate accounting. The board shall publish not less than once a year, all rules and regulations pertaining to this section. All decisions by the board under this section shall be subject to judicial review in an action prosecuted by the corporation in the district court of Lewis and Clark county. The taxpayer cannot change from one method of accounting to another method of accounting without first obtaining permission from the board."

DOR interprets the above statute as creating only two methods of determining income from sources within Montana—separate accounting or apportionment of total net income. Separate accounting is available only if income from sources within the state may be segregated from sources without the state. In the absence of the above conditions, total business net income must be apportioned.

DOR determined that the income classified by ASARCO as nonbusiness income was, in fact, business income as defined by DOR's 1967 regulations. DOR therefore restored this income to apportionable net income. In addition, DOR included in apportionable net income the net income of six of ASARCO's wholly owned subsidiaries. DOR contends that ASARCO and the six subsidiary corporations were engaged in a unitary business and therefore the combination was merely an extension of the apportionment method of taxation dictated by section 84–1503.

Pursuant to DOR's calculations of ASARCO's Montana income additional corporate license taxes were assessed. Protest was made by ASARCO and a hearing was held before the director of DOR. The director's decision affirmed the deficiency assessment. Thereafter ASARCO appealed to STAB which reversed the director's decision. DOR then petitioned the district court, Lewis and Clark County, requesting a review of the STAB order. On December 17, 1975, the district court entered judgment affirming the decision of STAB. DOR appeals the district court judgment.

Three issues are before the Court upon appeal:

(1) Whether DOR had the authority, pursuant to sections 84–1503 and 84–1508, R.C.M. 1947, to adopt its Regulations 1001–1020 (Chapter 10) concerning rules for the apportionment of corporate net income?

(2) Whether ASARCO was correct in its deduction of alleged nonbusiness income from apportionable net income prior to apportionment?

(3) Whether the income from six of ASARCO's wholly owned subsidiaries was properly included in apportionable net income?

On December 30, 1966, DOR adopted its Regulations 1001–1020 (Chapter 10). These regulations were effective with respect to tax years beginning on and after January 1, 1967. Included within these regulations are specific rules for allocation and apportionment of corporate income derived from sources both within and without Montana. In addition key terms are specifically defined as to their application to the regulations.

The regulations provide for two methods of accounting for income; apportionment according to a three-factor formula and separate accounting. Separate accounting is allowed only in situations where income can be specifically segregated as to source. Apportionment of income must be used in all other cases. The apportionment system adopts what may be categorized as a "business vs. nonbusiness" test in regard to determining what income is apportioned and what income may be allocated to source. Under this system all business income is apportioned by use of the three-factor formula while only nonbusiness income may be allocated to source. Business income is defined as all income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. Nonbusiness income is defined as all income other than business income.

ASARCO urges these regulations were ineffective as applied to it for the tax years 1967–1970 for two reasons:

1. DOR by virtue of section 84–1503 had the authority to adopt rules and regulations only as to the apportionment of such income as could not be segregated as to source.

2. The regulations adopt a "business vs. nonbusiness" income test rather than the "source" of income test found in section 84–1503 and are therefore fatally inconsistent.

Any contention that DOR lacks the authority to adopt rules and regulations interpreting taxation statutes is without merit. In regard to the statute in question, the power to adopt rules and regulations is clearly and unambiguously stated within the text of the statute. Furthermore section 84–1508, R.C.M. 1947, gives DOR power to provide "such other regulations as may from time to time be found necessary." We affirmed this principle in State ex. rel. Fulton v. District Court, 139 Mont. 573, 366 P.2d 435.

The crux of this entire case is the interpretation of section 84–1503 and DOR Regulations 1001–1020. There is no merit in ASARCO's contention that DOR has only authority to adopt rules and regulations for the apportionment of income incapable of segregation as to source.

The function of the Supreme Court when construing a statute is simply to ascertain and declare what is in substance stated therein, and not to insert what has been omitted or to omit what has been inserted. Dunphy v. Anaconda

Co., 151 Mont. 76, 438 P.2d 660; In re Transportation of School Children, 117 Mont. 618, 161 P.2d 901; Section 93-401-15, R.C.M. 1947. The fundamental rule of statutory construction is that the intent of the legislature controls. Matter of Senate Bill No. 23, Chapter 491, Montana Session Laws of 1973, 168 Mont. 102, 540 P.2d 975, 32 St.Rep. 954; Hammill v. Young, 168 Mont. 81, 540 P.2d 971, 32 St.Rep. 935; Dunphy v Anaconda Co., supra; Section 93-401-16, R.C.M. 1947. Where the intent of the legislature can be determined from the plain meaning of the words used, the courts may not go further and apply any other means of interpretation. State ex rel. Huffman v. District Court, 154 Mont. 201, 461 P.2d 847; Dunphy v. Anaconda Co., supra. Here, the plain meaning of the words used by the legislature unmistakably discloses its intent. DOR clearly has the authority to adopt rules and regulations as to the apportionment of corporate income without regard to source.

There also is no merit in ASARCO's second contention. ASARCO argues that section 84-1503 contains a "source of income" test to be used in determining apportionable income vs. allocatable income. ASARCO concludes that this apparent conflict with the business vs. nonbusiness income test found in the regulations, ASARCO points out that section 84-1503 was amended in 1974, and the amended statute conforms to the regulations.

In the construction of an amendatory act it will be presumed that the legislature, in passing it, intended to make some change in the existing law, and therefore the Court should endeavor to give effect to the amendment. Pilgeram v. Hass et al. 118 Mont. 431, 167 P.2d 339; Nichols v. School District No. 3, 87 Mont. 181, 287 P.624. However this presumption of change is not conclusive. This Court stated in School District No. 12 v. Pondera County, 89 Mont. 342, 297 P. 498, that a change in a statute may be made merely to express more clearly the original intent of the legislature. Such is the case here. The unamended statute is not a model of clear draftmanship in regard to guidelines for the apportionment of corporate income. DOR therefore adopted Regulations 1001-1020 to provide clear guidelines for taxpayer compliance. The legislature thereafter saw fit to clarify the section by the 1974 amendment to section 84-1503. The unamended version of section 84-1503 is not in conflict with the regulations and therefore ASARCO must report its income in compliance with those regulations.

Regarding ASARCO's second issue, we find the hybrid system of reporting income used by ASARCO to be invalid under section 84-1503. As above, the crux of this issue is the interpretation of section 84-1503 and Regulations 1001-1020. The intent of the legislature in regard to the determination of what income is apportionable income is clear and unambiguous. Section 84-1503 provides for two methods of accounting for income; separate accounting and apportionment.

Section 84-1503 provides a test for the determination of the correct method of accounting to be used by a corporation in reporting its Montana corporation license tax. If income from all sources within Montana can "be properly segregated from income without the state" then and only then, may the separate accounting method be used. Furthermore if the separate accounting method is applicable, total net income must be allocated to source rather than the hybrid system used by ASARCO.

ASARCO recognized its business was unitary in nature in 1962. It requested and was granted permission by DOR to discontinue the separate accounting system then in use. Hence both parties agree that ASARCO must apportion its income and the question becomes what income is included in apportionable net income.

The regulations are clear and simple. All business income is apportionable and nonbusiness income is allocated to source. ASARCO argues that certain items of income listed above are nonbusiness income and therefore properly deductible from apportionable net income. This contention in incorrect.

The regulations state that business income includes income derived from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operation. After an in-depth examination of the income in question, we find this income is derived from sources that are integral portions of its business. This finding is in direct conflict with the district court's finding of fact which state this income is nonbusiness income. The test of whether this income is in reality business or nonbusiness income is a matter of statutory

interpretation. We feel therefore that the finding of the district court is in error. We are confronted herein with a conclusion of law, rather than a finding of fact. Listed below are examples of the relationship of this alleged nonbusiness income to ASARCO.

(1) Royalty Income—The royalty income arose from two sources, mine royalties and patent royalties. The mine royalties arose when ASARCO leased its Keystone mine in Colorado to an unrelated mining concern. ASARCO had operated this mine prior to the leasing. The royalty was computed on the basis of mine production. The patent income arose from royalties paid for the use of devices developed by ASARCO's research department. These devices were developed initially for ASARCO's use in its various plants and mines. The main item included herein was a vertical feed furnace.

(2) Rental Income—The majority of this income is derived from homesites rented to employees working near ASARCO mines and plants. Mr. Pecca, an ASARCO official, testified at the DOR hearing:

"This is the, it's almost exclusively rents received from employees working at the company mines which are located in remote areas and the company is required to provide houses."

(3) Interest Income—The interest income arose from customers' notes on bonds, U.S. government notes, notes taken on the sale of a plant and stock, state and municipal bonds, and time certificates and other commercial paper. All were clearly liquid securities and were therefore readily available for use in meeting company obligations and debts.

(4) Gains on the Sale of Stock—ASARCO bought and sold stock in various corporations during the years in question. Included within the sales were stock of General Cable, Revere Copper, Kennicott Copper, and Hecla Mining Company. These corporations are all engaged in the business of either producing metal ore or manufacturing the refined product into goods. The stock was used by ASARCO for business purposes, such as gaining access to raw materials or access to potential customers for its refined metals. Therefore all of the above income was generated by the unitary business operation of ASARCO.

The concept of including income from sale of tangible and intangible property and income derived from rents, royalties and interest within apportionable net income is not new nor unique. In Sperry and Hutchinson Co. v. Department of Revenue, 270 Or. 329, 527 P.2d 729, 731, short term securities held to satisfy the need for liquid capital were held to be apportionable. The Oregon court stated:

"S & H argues that because this income is the return on an intangible it must be allocated to legal situs. Nothing in our former law requires such an arbitrary result and our current law expressly prohibits it." 527 P.2d 731.

The current law referred to by the Oregon court is in pertinent part identical to the DOR regulations here in question. A similar result dealing with short term intangibles was reached in Montgomery Ward & Co., Inc. v. Comm. of Taxation, 276 Minn. 479, 151 N.W.2d 294.

In Cleveland-Cliffs Iron Co. v. Michigan Corporation and Securities Commission, 351 Mich. 652, 88 N.W.2d 564, 572, the issue was whether an investment portfolio containing certain steel stocks should be included in determining the book net worth of the corporation. The court held the stocks were closely related to the company's business, quoting with approval from Flint v. Stone Tracy Company, 220 U.S. 107, 31 S.Ct. 342, 55 L.Ed. 389:

"Nor can it be justly said that investments have no real relation to the business transacted by a corporation. The possession of large assets is a business advantage of great value; it may give credit which will result in more economical business methods; it may give a standing which shall facilitate purchases; it may enable the corporation to enlarge the field of its activities and in many ways give it business standing and prestige." 88 N.W.2d 572.

See also: Great Lakes Pipe Line Co. v. Commissioner of Taxation, 272 Minn. 403, 138 N.W.2d 612.

Concerning the final issue, DOR is correct in its contention that net income and apportionment factors of six of ASARCO's wholly owned subsidiaries must be included in ASARCO's computation of apportionable net income. This is merely an extension of the unitary method of taxation. Simply stated, the traditional concept of a combination of various units of a corporation for unitary method tax computation is extended to a combination of various related or affiliated corporations.

In the instant case, the six affiliated corporations are clearly separate and distinct from ASARCO. However all are wholly owned by ASARCO and share common members of their respective boards of directors with ASARCO. A close relationship exists between ASARCO's business operation and the subsidiaries in that the subsidiaries all provide ASARCO with material, services, or a market for its products. From the discussion of the individual corporation's operations listed below, it is clear the corporations are dependent upon each other and each in turn contributes to the other's business success.

(1) Federated Metals of Canada—Federated Metals is a Canadian corporation which basically operates the same business in Canada as ASARCO's American operation. ASARCO provides Federated with certain central services such as operations technology and accounting and financial services. In addition, sales between the two corporations are significant.

(2) ASARCO Mercantile Company—ASARCO Mercantile is engaged solely in the purchase and sale of machinery for ASARCO's subsidiaries. All central services are provided by ASARCO.

(3) Enthone, Inc.—Enthone is a Connecticut corporation engaged in the manufacture and sale of metal finishing chemicals and supplies used in metal plating. About 16% of Enthone's raw materials were purchased from ASARCO. Central services were provided by ASARCO.

(4) International Metal Company—This company is ASARCO's exclusive sales outlet for materials delivered to foreign countries. ASARCO provides all central services.

(5) Lone Star Lead Construction Co.—Lone Star is a Texas corporation engaged in lining tanks with lead for protection against corrosive contents. The vast majority of its lead requirements are purchased from ASARCO.

(6) Northern Peru Mining Co.—All production from Northern Peru's mines are sold to ASARCO and refined in its plants.

In addition to the foregoing, Mr. Pecca testified as to other services provided by ASARCO to all its subsidiaries. These include:

1. ASARCO handles central insurance of the subsidiaries.

2. Services provided by ASARCO are billed to the subsidiaries, including top management.

3. All United States and state returns are prepared by ASARCO for the subsidiaries.

4. Legal services are provided by ASARCO for the subsidiaries whenever necessary.

5. Essential capital is provided for the subsidiaries, who do not go to outside sources without first going to ASARCO.

Coca Cola Company v. Department of Revenue, 271 Or. 517, 533 P.2d 788, 790, 792, is on all fours with the instant case. There the Oregon court said:

"The principal issue in this case is whether the income from Coca Cola and its wholly owned subsidiaries may be combined and the apportionment formula applied to the sum to determine the income properly attributable to Oregon." 535 P.2d 790.

The Oregon court first stated that in order to properly combine the incomes of the parent and subsidiary, the business operation must be unitary. The unitary test was defined as whether the business units, or in this case corporations, are dependent upon each other and contribute to the operation of the other's business. Zale-Salem, Inc. v. Tax Com., 237 Or. 261, 391 P.2d 601. Unquestionably this test is met in the instant case. The Oregon court in *Coca Cola Company* then stated:

"We must now decide whether the fact that Coca Cola and its wholly owned subsidiaries are organized as separate corporate entities precludes the Department of Revenue from combining their incomes to reflect the true character of their unitary business. We hold that it does not.

"* * *

"The question is fundamentally one of whether a business should stand in a better position for purposes of determining income merely because it chooses to use a multiple corporation organizational scheme. We do not feel that it should. We agree with the following statement of the California Supreme Court:

" '* * * [A]ccepting, as we must, the application of the law to unincorporated wholly controlled branches or businesses located in other jurisdictions as set forth in Butler Brothers v. McColgan, 17 Cal.2d 664, 111 P.2d 334; Id., 315 U.S.

501, 62 S.Ct. 701, 86 LEd. 991, the conclusion is irresistible that the same rule should apply to incorporated wholly controlled branches or businesses so located. * * *' Edison California Stores v. McColgan, supra at 473–74, 183 P.2d at 17."

The decision of the district court is reversed. This case is remanded to the district court with instructions to enter judgment in favor of the Montana Department of Revenue in the amount of the original deficiency assessment.

PAUL G. HATFIELD,
Chief Justice.

We concur:

GENE B. DALY,
JOHN CONWAY HARRISON,
FRANK I. HARWELL,
DANIEL J. SHEA,
Justices.

Mr. DE LOOZE. The court decided that six wholly owned subsidiaries of American Smelting & Refining Co. were unitary. One was in Canada. One was a domestic operating in Peru. It mined the ore and brought it into the United States for refining and smelting. Now there is no question that as an economic matter it doesn't make any difference whether that Peru corporation was incorporated in the United States or in Peru. In situations involving the United Kingdom or other countries, it makes no difference as to the economic consequences where a corporation is incorporated. There is still the same economic effect. Where is the product being used, and is it a part of the unitary operation? We think that it is very important that the committee understand the unitary operation, because you are asking us to throw out a very viable concept that seeks out what we call in the parlance of our administration, "nowhere income," income which is assigned nowhere, and makes the corporation account as to whether the income is actually reported or not reported.

ARM'S LENGTH VS. UNITARY CONCEPT

I would like to make one comment with respect to the arm's length versus the unitary concept. I know the committee probably will not decide this on the basis of some kind of technical analysis of the two systems. The unitary concept seeks to determine whether there is a taxable net income from the economic enterprise. It does not apply unless there are affiliated corporations which are interrelated and correlated and dependent on each other.

Under the arm's length concept you can find a profit with any corporation, the raw material corporation, the manufacturing corporation, or the selling corporation. Now the Internal Revenue Service might find that the manufacturing corporation had a profit. Under the unitary concept unless the enterprise as a whole had a profit there would be no taxable income. I think you could say under the arm's length concept you might have arbitrary determinations of taxable income where, in fact, there is none. I would like to also point out that there is precedent for the Internal Revenue Service to use the unitary concept.

In 1962 the Treasury Department introduced the Revenue Act of 1962. In that they asked for specific authority to use a combination method with respect to foreign affiliates. The bill went to conference

committee and the committee determined that there was sufficient authority under section 482 of the Internal Revenue Code to let them use the unitary idea. In fact if you will look at section 482 you will notice it says "apportion" or "allocate." It does not just say allocate. Apportion means to divide. Allocate means to assign. But the Treasury Department chose in its regulations that it promulgated about 1967 or 1968 to ignore the unitary concept and go to the arm's length method. Now that we say, and I won't go into any great detail, has in it the seeds of its own death. As an example, if the final price at which the corporation sells its product is an artificial price in a marketplace created by the corporation because of its unique position how are you going to determine prices between its affiliates when you start out with an artificial market price in the first place?

I will say also that any criticisms of the unitary concept with respect to accounting records, et cetera, are also applicable to the arm's length concept. Certainly the arm's length concept requires audit, requires books and records, requires everything you will find in the unitary concept and even more so. I don't think anybody can state that the unitary concept creates a greater burden on corporations than the arm's length concept. It is much simpler, as we have indicated, it is much simpler to apply and has the benefit of only determining whether there is net taxable income, not some artificial income.

END RUN AROUND CONGRESS SUGGESTED

I don't think there is any question that this treaty provision constitutes an end run around what Congress was already considering. I would like to reemphasize that. The question was raised as to the history of legislation that has been introduced in the Congress. In 1969 the Ribicoff proposal, which was one of a series of bills, would have specifically precluded combination or consolidation. This issue has been before Congress.

Last year, Mr. Hamilton of California and I testified before the task force subcommittee. At the same time we visited the Treasury Department asking them to consider the unitary concept. We met with a stone wall. It seems to me if they knew, which they must have known, that the idea was before Congress and has been considered by Congress, that putting it in the treaty without any announcement must constitute an end run around Congress.

Thank you.

[Mr. de Looze's prepared statement follows:]

PREPARED STATEMENT OF OREGON DEPARTMENT OF REVENUE, PRESENTED BY THEODORE W. DE LOOZE, CHIEF TAX COUNSEL, OREGON DEPARTMENT OF JUSTICE

The State of Oregon, through its Department of Revenue, requests the Foreign Relations Committee of the United States Senate to recommenl to that body that portions of paragraph (1) and (2) of Article 2, and paragraph 4 of Article 9 of the United States-United Nationl Income Tax Treaty be reserved.

The sections of the treaty referred to constitute a precedent that, if not stopped *ab initio*, will be followed in other treaties. The effect of this and similar treaties would be that certain corporations subject to taxation by the State of Oregon would be in a preferential position with respect to the determination of net income properly attributable to and taxable by the State of Oregon.

The provisions requested to be reserved are paragraph 4 of Article 9, and the

portions in paragraphs 1 and 2 of Article 2 that are underlined. They are as follows:

ARTICLE 2

"This Convention shall apply to taxes on income imposed by each Contracting State *and as hereinafter provided to taxes imposed by its political subdivisions or local authorities.*

"(2) The existing taxes to which this Convention shall apply are:

"* * *

"(c) *for the purposes of paragraph (4) of Article 9 (Associated enterprises), taxes imposed on income by political subdivisions or local authorities of a Contracting State.*

ARTICLE 9

"* * *

"(4) Except as specifically provided in this Article:

"(a) where an enterprise doing business in one Contracting State:

"(i) is a resident of the other Contracting State; or

"(ii) is controlled, directly or indirectly, by an enterprise which is a resident of the other Contracting State; and

"(b) where the enterprise which is a resident of the other Contracting State is a corporation, such corporation is neither:

"(i) a controlled foreign corporation within the meaning of section 957, of the United States Internal Revenue Code of 1954 (as it may be amended from time to time without changing the general principle thereof); nor

"(ii) created or organized under the laws of the first-mentioned State or of any third State or controlled directly or indirectly, by a corporation which is a resident of any third State;

"then, in determining the tax liability of the first-mentioned enterprise in the State in which it does business, or in a political subdivision or local authority of that State, such State, political subdivision or local authority shall not take into account the income, deductions, receipts or outgoings of a related enterprise which is a resident of the other Contracting State or of an enterprise of any third State which is related to the enterprise of the other Contracting State except that his prohibition shall not apply where the first-mentioned enterprise is a resident of the first-mentioned Contracting State, to the extent that it owns, directly or indirectly, the capital of the related enterprise."

The effect of these provisions is illustrated in the technical explanation released on March 9, 1977 by the Department of the Treasury in its "Department of the Treasury News", at page 21:

"The following is an ilustration of the operation of this paragraph: Corporation M, organized under the laws of the United Kingdom, is a resident of the United Kingdom, and all of its stock is owned by individuals residing in the United Kingdom who are not United States nationals. Corporation M controls subsidiaries A, B, and C, which are incorporated in, and do business in, respectively, France, Germany, and Belgium. Corporation M also controls a United States subsidiary, Z, which is incorporated and conducts its business in X, a state of the United States. In determining the tax liability of Z, to X or to the United States, neither X nor the United States, are permitted to allocate to, apportion to, or otherwise include in Z's tax base income earned by M, A, B, or C, except to the extent the dealings between Z and those persons require the application of the arm's-length principles of the other paragraphs of this Article. Thus, in these circumstances, the United States or the states will be required to determine Z's tax liability solely on the basis of its income. The determination of Z's taxiliability under any unitary or combined reporting basis is, therefore, prohibited by this Article."

SUMMARY OF OBJECTIONS

The State of Oregon objects to these portions of the treaty for the following reasons:

(1) Inequities are created between taxpayers because of the preferred position of United Kingdom companies operating in unitary tax states, relative to companies located in other countries.

(2) The approval of these provisions will inevitably lead to their inclusion in other treaties. In any event, the ratification of this provision in this treaty and ratification of similar provisions in other treaties will result in discrimination in the taxation of United States enterprises doing business in foreign coun-

tries where the method of operation does not fall within these provisions. Thus, where the enterprise doing business in the United States is not a resident of the United Kingdom or is not controlled, directly or indirectly, by an enterprise which is a resident of the United Kingdom, tax discrimination will result.

(3) This is the first time that the United States has utilized a treaty with a foreign nation as a method of determining the tax base of a United States political subdivision, such as the State of Oregon. Ordinarily, limitations are requested in the United States Congress, where there is a regular procedure for hearing objections, and an opportunity for all interested parties to present their views. This hearing before this Committee represents the first public hearing on this question.

(4) The approval of this provision may give rise to litigation based upon the type of discrimination described above, since undoubtedly the argument will be made that the foreign-based multinationals are receiving a competitive advantage. Such litigation undoubtedly would tie up millions of dollars of tax revenues in the states affected, in addition to the direct tax loss resulting from application of the treaty provisions. The extent and outcome of such litigation is troublesome to predict.

(5) Approval would be a serious step backwards in tax theory and tax administration, with the concomitant approval of an unworkable method of finding tax deficiencies. More particularly, the unitary method automatically adjusts the effects of arrangements and agreements between economic business units in the determination of prices and profits; the so-called "arm's-length" method utilized under section 482 of the Internal Revenue Code and directed by paragraphs 1–3 of Article 9 of this treaty is archaic, cumbersome, and necessarily haphazardous in its application.

(6) The State of Oregon estimates a probable tax loss per year of from $4 to $6 million.

THE LONG TIME USE OF THE UNITARY METHOD BY OREGON

1. What is the unitary method?

The application and understanding of the unitary method is simple. It originated in California and provides an effective method of dealing with arrangements and agreements between branches or divisions within a corporation or between separately incorporated parts of an economic enterprise. It has the beauty of resolving all the pricing, expense and other audit complexities that go into a multinational business operation which develops a raw material into a saleable and sold finished product. Thus, the following simple example applies to more complex business situations.

A multinational corporation has subsidiary A, which is a resident of the United Kingdom. The subsidiary provides wool in the manufacture of men's suits. The wool is manufactured by subsidiary B in West Germany and the finished product is shipped to the United States and elsewhere for sale. The parent acts as a sales organization and sells the suits to Oregon outlets. Oregon has jurisdiction because the activities exceed mere solicitation unde Public Law 86–272. In this situation it is entirely possible to place the profit in any one of the three companies or countries involved. The sale of the wool by subsidiary A to the manufacturing subsidiary B could be at cost. Os substantially all the profit involved could be included in the price to subsidiary B. Or, B could manufacture and sell the suits to the parent at its cost which might or might not A to the manufacturing subsidiary B could be at cost. Or substantially all the profit from the sale of the suits, except for the expenses of sale incurred by the parent. Thus the profit could be placed in Great Britain, Germany, or the United States, depending upon such things as federal tax consequences. However, there is only one profit from the sale of suits, and consideration of all the activities of the integrated economic enterprise is necessary to determine the net profit from the activities of the three corporations.

Application of the unitary concept eliminates all intercompany sales so that intercompany non-market pricing is nullified. Misallocation of expenses also are nullified so that there is only a consideration of the actual cost involved in producing the end result—the net profit of the economic enterprise. Thus, it makes no difference under the unitary concept whether the net income or profit is attributed to the raw material subsidiary, the manufacturing subsidiary, or the selling parent. The economic net profit is then apportioned. Since Oregon uses the three factor formula of the Uniform Division of Income for Tax Purposes

Act, Oregon's share would be based on application of an averaged three factor formula of property, payroll and sales in Oregon to property, payroll and sales everywhere.

In this "simple" example, it might be possible for a Section 482—"arm's length" examination to be made by auditors of the Internal Revenue Service. However, the situation might be complicated by numerous problems such as the existence of a market for the product in its raw, semi-manufactured, or finished condition at any stage, the treatment of expenses and overhead, difference in accounting methods by any one or all three of the corporations involved, the existence of inter-company loans, and the like. For a complete discussion of the vast number of situations that would have to be analyzed by an auditor under the "arm's legnth" concept, see attachment 3 of the California position paper.

2. How long has Oregon used the Unitary Concept?

Oregon adopted the unitary concept in 1955, with respect to domestic corporations. As each corporation came up for audit review, it was examined and the unitary concept utilized wherever applicable. It has been applied uniformly whether it results in additional taxes or a refund. In the course of review the concept has been affirmed by the Oregon Supreme Court, both as to horizontally or vertically integrated corporations. See *Zale-Salem, Inc.* v. *Tax Comm.*, 231 Or 261, 391 P2d 601 (1964) (retail stores) and *Coca-cola Co.* v. *Dept. of Revenue*, 271 Or 517, 533 P2d 788 (1975) (manufacture and sale of syrup and bottling of soft drinks).

Oregon began application of this unitary theory to world wide operations about 1967 when it opened its New York office. Since then, it has applied it as audit review progresses among the companies. Some companies have requested world-wide combination, presumably because they have reported to California on that basis, or because it proved to be beneficial, tax-wise. About 4,500 to 5,000 foreign corporations are doing business in Oregon and other states. They are being examined in the audit process as to whether they are properly subject to worldwide combination. Not all have been examined; and certainly not all are operating outside the United States.

3. Are California and Oregon unique in its application?

The concept has been applied and accepted by the courts both with respect to the single corporate shell with separate activities carried on by divisions or branches within the corporation, and where there are separate incorporations of the various parts of the economic activity. The test in each case is the same: is there a unitary operation? The extension from the single corporation to the affiliated corporations in the domestic situation, and the subsequent extension to worldwide operations is a natural extension of the combined method of reporting and has been recognized as such by the courts. Without attempting to enumerate all the states that have adopted the unitary concept in one aspect or another, suffice it to state that the latest pronouncement appears to be by the Supreme Court of Montana in *American Smelter and Refining Company* v. *Montana Department of Revenue*, decided July 11, 1977. In that case, the Court approved the combining of ASARCO and six wholly-owned subsidiaries. These subsidiaries and their functions in relationship to the parent were:

(1) Federated Metals of Canada. This company performed in Canada the same kinds of operations as were conducted through the Federated Metals Division of ASARCO, i.e., dealing with the non-ferrous alloy operation.

(2) Asarco Mercantile Company. This company engaged in the purchase and sale of machinery and equipment for Asarco's subsidiaries.

(3) Enthone, Inc. This company engaged in the manufacture and sale of metal finishing chemicals and supplies used in metal plating.

(4) International Metal Company. This company conducted the sales operation for Asarco of sales to foreign customers.

(5) Lone Star Lead Construction Company. This company lined tanks with lead where corrosive products were used.

(6) Northern Peru Mining Corporation. This company was located in Peru and mined copper, lead, silver, and zinc for production in Asarco's plants.

The case demonstrates that the unitary concept might apply both with respect to (1) a single corporation's activities, (2) activities conducted with domestic subsidiaries, and (3) activities conducted through a foreign subsidiary. Since 1962 Asarco had reported the activities of its single corporation on a unitary basis. The activities of that corporation covered the operation of primary metal

mines in Colorado, Washington, Arizona, New Mexico, Idaho, Canada, and foreign countries, the operation of smelters and refineries in Texas, Maryland, Colorado, Montana, Missouri, Arizona, Nebraska, New Jersey, and Washington. It covered the operation of refineries and the sale of the products sold out of the New York office. It further covered the manufacture and sale of nonferrous alloys including plants in Texas, New Jersey, California, Oklahoma and Indiana and the sales offices in nine major United States cities. Finally, it covered exploration activities for additional sources of metal. For whatever business reasons were pertinent, Asarco also operated through wholly owned subsidiaries. The Montana Supreme Court decision determined that these were part of the unitary operation. One Canadian subsidiary was also included. Not all of Asarco's subsidiaries were included in the audit at that time, but it is possible the total worldwide operations of Asarco are unitary.

"Imposition of the Treaty Provisions on Oregon and Similarly Situated States Would Make It Virtually Impossible to Stop Erroneous Allocations of Income Between Related Enterprises."

It is not the purpose of this paper to assert that all allocations of income between related enterprises in an economic operation are made intentionally or for tax consequences. But allocations of income, whether intentional or unintentional, direct or indirect, may be just as in need of adjustment as where there are intentional arrangements or agreements between related enterprises designed to place income in certain companies or countries.

It is of extreme importance to note that Article 9 of the Treaty contains in paragraphs (1), (2), and (3), provisions for so-called "arms-length adjustments" between the two countries. The test in these provisions is not a test of intention to avoid tax consequences. Paragraph (1) of Article 9 provides as follows:

"Where an enterprise of a Contracting State is related to another enterprise and conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any income, deductions, receipts, or outgoings which would, but for those conditions, have been attributed to one of the enterprises but by reason of those conditions have not been so attributed, may be taken into account in computing the profits or losses of that enterprise and taxed accordingly."

Paragraph (2) requires the other contracting state to make appropriate adjustments and paragraph (3) provides for use of the mutual agreement procedure in Article 25 if the two contracting states do not agree upon the adjustment.

By including these provisions in the treaty, the United States Treasury Department has admitted that situations arise which require adjustment. These provisions confirm the authority of the United States under Section 482 of the Internal Revenue Code to apply the so-called "arms-length test". Section 482 provides as follows:

"In any case of two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

This "arms-length" method, doggedly adhered to by the United States Treasury Department, has proven to be difficult and inefficient, and has been subjected to severe criticism. See the California position paper, attachment 3. It requires an imposible standard, the estimation of the workings of a worldwide marketplace which might not even exist. It might be true that where the problem has arisen because of the activities of two related enterprises, no similar market between similar enterprises could be found. It is almost impossible to conjecture the army of auditors that would have to be employed and the number of arbitrary decisions that would have to be made in any complex international situation, for the United States Treasury Department itself to apply paragraphs (1), (2), (3) of Article 9, except in the most obvious and outrageous situations. The application of these provisions first requires proof that conditions have been made or imposed between the two enterprises. It then requires the unraveling of the economic consequences and perhaps the creation of an equally artificial market pricing.

Where does this provision leave the states that operate under the unitary concept? It would seem that they would be left to rely upon the extent to which the Internal Revenue Service utilized paragraphs (1), (2), (3) and Section 482, and the various exchange agreements between the Internal Revenue Service and the states. In no way could an individual state effectuate paragraphs (1), (2), (3). In the first place there is no indication that it was intended to be applied by a political subdivision of the contracting state, since they are expliictly not mentioned in these paragraphs, as they are in paragraph (4). And even if they were mentioned, this Congress itself has noticed a virtual impossibility of application by a state. In its report entitled "Recommendations of the Task Force on Foreign Source Income" the Committee on Ways and Means, U.S. House of Representatives, 95th Congress, 1st Session, dated March 8, 1977, states at page 27–28:

"For Federal income tax purposes, an apportionment formula is not used to divide income and costs between United States and foreign countries. Instead, income and costs are allocated between related companies using the criterion of what the costs and prices would be between these parties if they were independent parties dealing at arm's length (sec. 482). On the other hand, in computing what portion of the income of a single company is from foreign sources, an allocation of income and deductions approach is used (sec. 861). This approach already produces significant problems when applied at the Federal level *and would be virtually impossible to administer at the State level as applied to interstate transactions.* Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or foreign countries)."

The conclusion is inescapable that the treaty provisions could nullify effective elimination of discrimination between taxpayers now possible through the application of the unitary concept. In no way would the automatically simple, clean-cut and effective operation of the unitary concept be matched by an auditing juggernaut trying to outguess hypothetical operations of international markets under the arms-length standard method. The only thing that can be said for that method is that it might help create full employment.

ACHIEVING FULL ACCOUNTABILITY AS TO TAXABLE INCOME

Several times, representatives of California and Oregon have suggested to federal officials that the United States government itself should look at the unitary method in its taxation of foreign source income. The United States would benefit from a truer picture of the total net income earned by the economic enterprise. If tax breaks are to be given as a matter of federal policy, they can be given by use of reduced tax rates, deductions, and tax credits. The United States and its political subdivisions (the states) could correlate their activities and not be at odds in their admiinstrative procedures designed to effectuate full accountability. At the present time it would seem obvious that full accountability on the Federal government's side of the tax picture suffers.

The argument is often made that the use of unitary method imports income into the United States because the costs of doing business are less in foreign countries. This argument was also considered by the Committee on Ways and Means in their task force study referred to above. At page 28 the report states that in any specific case this matter might not be true depending upon the proportion of income to wages, property cost, and sales in the specific country in which the corporation operates. Even assuming, *arguendo*, that a United States corporation can operate through a foreign subsidiary at a higher rate of return per dollar of investment, it seems only just that some of the economic advantage accruing to the corporation operating outside the United States should return to the United States in the form of taxes which in some way offset the costs of unemployment in the United States and their political subdivisions because of the employment of foreign labor. In general, however, the argument with respect to foreign costs of doing business merely serves to emphasize the over-

all difficulty in allocating income to any income-producing factor in a business enterprise. The foreign affiliate may be directed by United States management whose efficiency and brilliance cannot be measured in salary dollars, but whose activities, nevertheless, might be much more important in the earning of the income than the low-paid factory worker in the foreign plant. Once foreign money is translated into dollar equivalents, the unitary operation admittedly does serve to uniformly attribute to the same formulary dollar the same rate of return. But the advantage is that it eliminates misallocations attributable to corporate audit techniques and says, in brief, that if the activity is worth paying for as a part of the total operation, it must be credited with its pro rata share of the net income being earned.

It is suggested that the United States government should put its efforts towards the adoption of the unitary policy in cooperation with its progressive states that are seeking tax equity and ease of administration, rather than perpetuating or creating new tax jungles of administrative impossibilities.

The following note appeared under the heading of *Briefs* in the June 29 issue of *The Wall Street Journal*:

"Businesses with U.S. and Canadian operations may be audited simultaneously by both countries. A recent agreement calls for sharing audit information and coordinating simultaneous audits of taxpayers operating in both places."

Under our dual system of government, if the federal government, as a matter of policy, chooses to follow an archaic system for determining the income of multinational corporations, knowing that the system has within the seeds of its own defeat, it is entitled to do so. However, Oregon cannot understand why such a system must be mandated upon Oregon and other states which have developed a fair and more equitable method for determining the income of multi-national corporations attributable to a particular state.

Senator CHURCH. I will say that I entertain that suspicion.

POSSIBILITY OF RESERVATION

One panelist made the statement, is this unitary tax provision in the U.S. treaty really necessary, whether the unitary provision was really necessary to the treaty.

We had testimony yesterday that would indicate that the treaty would have beneficial effect both for us and for the United Kingdom if this unitary provision was simply outlawed. So we had testimony that the British would then have to reconsider. If reservations were entered into the system of ratification then that would give the British an opportunity to reconsider and decide whether they would wish to enter the treaty on that basis. The testimony, however, suggests that there are other provisions in the treaty which might very well serve the interest of the United Kingdom. We can't pass judgment on that, of course. That is something that we should look at carefully.

I think there is a possibility of reservation on this particular question. It is something that the committee should consider, Mr. Chairman.

I have no further questions of the panelist. Senator Sparkman, do you have a question?

END RUN AROUND CONGRESS

Senator SPARKMAN. You cautioned us in your final statement not to let them end run around Congress. I don't know that I understand what you mean by that because how can they end run around Congress when Congress and this committee must participate in any treaty.

Mr. CORY. The thing we are looking at is that these issues have been before the other House, the House of Representatives, and Senate committees and joint committees.

They have studied them in detail with respect to minutia of tax policy and have come to the conclusion that bills prohibiting the States ability to impose this tax in this manner have not been passed and that when the special interests could not get their desires that way then they go through the treaty process where they only have to deal with one House of Congress and with a different committee and a committee that, with all due respect, I think does not have the time to really get into the detailed cost accounting problems, internal accounting of vertically integrated corporations, that relate to this tax question.

It would take several days of testimony to really understand what this means in terms of tax collection.

I would not want to waste your time with that kind of detail. If you want to hear it we can get the technicians for you, but it is very complex. What we are saying is that this is an attempt to try to get it in a forum where they don't have to deal with the facts but deal with it on a superficial level and try to move it that way.

As you divide your labors in the Senate on subject matters, those people who normally toil in the area of taxation are not called upon on this question.

I think this is the end run we are talking about, not trying to make any offense to this committee and your powers and your prerogatives.

I really put my foot in it, didn't I?

Senator SPARKMAN. With the treatymaking process in mind as long as it comes before us in the form of treaty then this committee has jurisdiction over it, must handle it, and if approved must report it to the Senate. Then it is taken up in the Senate and debated.

It is a one Chamber process.

If you are going to involve a treaty, then I don't quite see where the other House enters into it. Of course, if anyone there wants to introduce a legislative proposal relating to the conditions, that can be done.

As long as it is a treaty, then of course the Senate is the only body to consider it. You agree with that?

Mr. CORY. Clearly, sir.

Senator CHURCH. I think that is the point of argument they make, that it does not have to go before the Congress.

Senator SPARKMAN. Since they brought it here I assume it relates to the officials in the executive department who made the determination.

Of course, they have that right the same as any Member of Congress has the right to introduce a bill whenever he wishes. So it seems to me we have to consider it on that basis. It is not something that can be shunted away. It seems to me that we have a lot of processing to do. I hope we can move right to it with dispatch and not hold it up too long.

Mr. Chairman, I am going to have to go to the Senate floor at this time.

Senator CHURCH. Thank you very much, Mr. Chairman, for attending this morning.

Senator Javits, do you have any questions?

Senator JAVITS. Yes.

CHARGE OF END RUN

Mr. Cory, I heard what you said, but I did not get too clearly your statement about somebody making an end run around somebody. Who is making an end run around whom?

Mr. CORY. It seems to me that those interests who benefit in the prohibition of the application of the unitary concept tend to be the multinational companies and from our analysis of the tax returns in California, among those companies who benefit most—slightly over 50 percent of the benefit or the loss, depending on which side of the table you are on—slightly over half are from the multinational oil industry.

If you want to know who it is, I think that is who it is. I think when you analyze the fact that British Petroleum, BP, which is 50 percent owned by the British Crown, is moving into this Nation with its ownership in Alaska and its acquisition of Sohio, which puts them in a very unique position where California and the oil terminal there will be a very significant part of their program, I can clearly understand why a U.K. treaty is the mechanism. In fact that is who it is. That is my own personal opinion.

Senator JAVITS. That is the only evidence you produce for the charge?

Mr. CORY. I produce evidence that the tax loss to the State of California from the treaty as originally presented was $125 million and of that $125, $60 million of it was the oil industry.

I suggest that that is an indication that they are the beneficiaries.

Senator JAVITS. But that is your only evidence? That is your case?

Mr. CORY. As to who benefits.

Senator JAVITS. Not as to who benefits. You said somebody was designing an end run around somebody else.

Mr. CORY. The further evidence is included in this book, the last section, which is page after page on the various pieces of legislation introduced in both the Senate and the House which would statutorily remove our power, and the legislative history of each of those is failure.

There is in addition to that a series of court cases going back to 1924 where those people who have been subject to the unitary concept have said no, this is not right legally, and they have taken those various cases through the various State courts, to the U.S. Supreme Court, and have lost in the judicial arena.

That is I think the total.

Senator JAVITS. That is your total evidence that some kind of conspiracy applies.

Mr. CORY. I did not use conspiracy.

Senator JAVITS. What did you use? What do the words "end run" mean?

Mr. CORY. I thought it was an end run around the full legislative process. I did not mean to imply any conspiracy in that regard.

Senator JAVITS. Does not the Constitution of the United States provide for treaties approved by two-thirds of the Senate as much as it provides for laws passed by both Houses and signed by the President?

Mr. CORY. Very clearly, Senator. That is why in my opening comments I made the statement that we don't challenge your right to do so. We are only suggesting that it is not good wisdom to proceed.

Senator JAVITS. Now wisdom is another matter. But conspiracy or end runs are very different charges, and they need evidence, especially when the Treasury of the United States is against you.

U.S. TREASURY'S VIEW OF UNITARY APPORTIONMENT

I would like the record to include, Mr. Chairman, a letter of February 15, 1977, addressed to Martin Huff, the executive officer of the California Franchise Tax Board by the Secretary of the Treasury in which he says as follows:

The unitary apportionment system is inconsistent with the accepted tax treaty policy which prohibits one country from taxing the business profit of an enterprise of the other unless that enterprise is engaged in the business through a permanent establishment in the first country.

Then he goes on to state:

Though you state,

this being Mr. Huff,

that unitary apportionment is the "most accurate and reasonable method yet provided" for assessing the income of one element in a multinational group, it is our experience as well as that of most other countries that the determination of income on the basis of an arm's length standard is not only more accurate but also is far less arbitrary.

Mr. Cory, do you have any comment on that?

Mr. CORY. The testimony before the Joint Committee on Taxation of Congress provided, I think they made a presentation yesterday, that 40 percent of the 42 cases of multinational companies use a unitary apportionment concept, the one which the Secretary doesn't like too well. That is an area where reasonable people can differ.

The fact seems to indicate that the IRS under 482 is using unitary in 40 percent of the cases. To say to us that we can't use it at all, there has to be a presumption of an arm's length, where their only experience shows that in 40 percent of the cases they have been unable to, it is inappropriate.

Senator JAVITS. I intend myself to ask the IRS and Treasury to comment on your testimony and give us their version of the case so that the record may be complete on this score.

EXTENT OF UNITARY TAX CONCEPT USE

Also, I notice your statement in this book—on page 4 in which it appears from this matter that you testify to that 31 States have some form of unitary tax usage.

Now will you be kind enough to refer to page 4. That refers apparently to a questionnaire sent by a Professor Schoettle or a survey made by the State of Indiana based upon a questionnaire they sent in October of 1976 asking the question and then your statement says all 50 States and the District of Columbia responded. Thirty-one States answered yes, and 14 said no.

Now the question that was asked was as follows:

Are there any situations in which your state goes beyond the corporate shell to consider the unitary corporate business in determining the income tax base? That is, are there any situations in which your state takes into consideration activities of related corporations in determining the income tax of a corporate taxpayer?

You say 31 States answered yes.

Is that the totality of what you mean when you answered that 31 States use the unitary tax concept to some extent? That is what you base it on?

Mr. CORY. Yes.

Senator JAVITS. The answer to this question?

Mr. CORY. Yes, sir.

Senator JAVITS. Would it be too much trouble for you—if so, we can get it done ourselves—to give us a chart showing how and to what extent 31 States aplied this unitary tax concept? The fact that they answered yes to this question does not seem very meaningful to me.

Mr. CORY. There is a subjective element to your question. I think we are prepared to do the best we can to provide the information. There is a subjective element that I would like some delineation on, how to quantify the extent.

Senator JAVITS. You made a statement. You said 31 States use to some extent the unitary tax concept. You base your statement upon the answer to this questionnaire. All I ask is, give us the detail.

Mr. CORY. We can identify which States they are, but if you want us on the chart to show to what extent Alaska and to what extent Michigan uses it, that is a subjective evaluation, and I am not quite sure how you want that detailed?

Senator JAVITS. It is not what I want, Mr. Cory. It is what you want to prove to us. You are making the case on the ground that while only at the most 4 States use the unitary tax method for taxing foreign corporations, there are 31 really who are involved. That is your statement.

I would like to know what your claim is the extent of their involvement; that is all.

Mr. CORY. We will get that information to you.

Senator JAVITS. It may have important probative force or it may not. But let us have it. I just want to get specific about it. I think that is a serious and important question. I must say that apparently you are in disagreement with the Treasury which is also a very serious and important question for us. I thoroughly agree with our chairman that your State is entitled to all the dignity and importance of a State, and we must look into your views very, very carefully. Though my questions may be searching, Senator Church knows me well, knows that that is not necessarily an indication of my position.

Mr. CORY. Senator, the reason for my question was having sat on that side in the California Legislature I was trying to find out how you wanted me to quantify extent.

Senator JAVITS. Give us your view. When you say subjective it should be your subjective view. You are trying to prove something to us. We would like to know what is the proof. That is the reason for the searching nature of my questions. I thoroughly agree this is a very responsible and respectable proposition which we should examine very carefully.

Senator Sparkman is right that it is a treaty with another country very friendly to the United States. We can't be more careful about this thing either way, especially where you have a number of our States juxtaposed through an international relationship.

Second. I think we have the power. When I say we, I think the Constitution vests the power in the Congress. Whether we should use it is a question.

Thank you very much.

I did not want you to feel I was in any way unfriendly, but we do have to be searching.

POSITION OF GOVERNOR OF CALIFORNIA

Mr. CORY. I left one thing out of my statement. There was some testimony yesterday about somebody questioning what the Governor of the State of California's position was on this matter. He sent a letter to Senator Sparkman some time ago. I would hope that that letter is in the record.

Last week when we had a hearing before the franchise tax board, the secretary of the business and transportation agency, a recent appointee of the Governor, stated his concern about taking the power by treaty mechanism.

He also expressed concern about the specific application in certain aberrations of the formula. He expressed that concern, a very legitimate concern shared by the franchise tax board. Another gentleman also is a person who is frequently characterized as the Governor's top political strategist who is Mr. Tom Quinn who has been quoted previously in newspapers suggesting some problems with the unitary tax, and he made the explicit statement before our board last week that the Governor stands by his letter. I think that is important to have in the record.

Senator CHURCH. Thank you.

WITNESSES

The next panel consists of: Robert M. Norris, president, National Trade Council, New York, N.Y.; Ernest S. Christian, Jr., Patton, Boggs & Blow, on behalf of the Committee on State Taxation, Council of State Chambers of Commerce, Washington, D.C.; John S. Nolan, Miller & Chevalier, on behalf of the British National Committee of the International Chamber of Commerce and the Confederation of British Industry, Washington, D.C.; Ernest I. Reveal, president, R. T. French Co., Rochester, N.Y.; Valentine Brookes, Brookes & Vegl, on behalf of EMI-Capitol Records, Inc., San Francisco, Calif.; Charles M. Walker, Paul, Hastings, Janofsky & Walker, on behalf of himself, former Assistant Secretary of the Treasury for Tax Policy, Los Angeles, Calif.; Andrew W. Gotelli, Peat, Marwick, Mitchell & Co., on behalf of California Council for International Trade, San Francisco, Calif.; Carl A. Stutsman, Jr., Hill, Farmer & Burrill, on behalf of Los Angeles Area Chamber of Commerce, Los Angeles, Calif; and Paul Berger, Berger, Berger, Kahn & Shafson, on behalf of the Screen Actors Guild, Beverly Hills, Calif.

Senator CHURCH. I would hope, gentlemen, that you could follow the procedure I mentioned before. If you have prepared statements, submit them for the record and summarize the points. I would like your arguments in summary form, please.

Robert Norris, president of the National Trade Council will be first.

STATEMENT OF ROBERT M. NORRIS, PRESIDENT, NATIONAL TRADE COUNCIL, NEW YORK, N.Y.; ACCOMPANIED BY WILLIAM J. HANLON, MEMBER OF THE TAX COMMITTEE

Mr. NORRIS. Mr. Chairman, I am accompanied this morning by Mr. William J. Hanlon, a member of our tax committee. If the questions get too technical, I am sure he will be able to handle them.

Essentially our membership which is comprised of a broad cross section of diversified interests from all over the country engaged in international trade investment strongly urges this committee to recommend ratification of the Tax Convention.

I will focus this morning on two features only of the convention which we consider to be most vital.

First, is the importance of the convention as it relates to the coordination between a classical system of taxation such as the one we employ in the United States and an imputation system of taxation such as the one employed by the United Kingdom.

The second point that I want to zero in on is the provision of the convention that relates to the matter of taxation of multinational enterprises by political subdivisions of the United States and the United Kingdom.

ARTICLE 10 OF U.S.-U.K. TAX TREATY

Now, the proposed convention under article 10 would permit the partial refund of the United Kingdom of an advance tax corporation's tax, the acronym of which is ACT, paid with respect to distributions paid to U.S. corporation shareholders. We believe this represents a very important step in minimizing the extent of discriminatory tax treatment of U.S. investors abroad.

Generally the effect of this provision would reduce the U.K. tax burden on fully distributed earnings to approximately 42 percent, at which point there would be additional U.S. tax due of approximately 6 percent on those earnings when they are received here by the U.S. shareholders. The U.S. shareholders would thus get approximately 52 percent of the distributed earnings, but if this refund provision is not available under the Tax Convention, the U.K. tax burden on fully distributed earnings would be 52 percent. There would be no residual U.S. tax due on the distribution.

The U.S. shareholder obviously would therefore net 48 percent. The absence of a refund provision would obviously also result in less tax revenue to the U.S. Treasury and generally a higher total tax burden to the U.S. investor.

We also attach importance to the fact that the refund provision under the convention would be very valuable in connection with negotiating income tax conventions with other countries which employ the imputation system of taxation or variations thereof. We think it is clearly in the interest of the United States to encourage foreign tax authorities not to discriminate against U.S. investors.

As I have indicated, we believe that the proposed convention is an important step in the right direction to reduce such discrimination.

Senator CHURCH. I would like to tell you at that point I agree with you. I think that is a very valuable part of the treaty. I don't think the committee would quarrel with that provision.

Mr. NORRIS. Thank you very much, Mr. Chairman.

On the second point, Mr. Chairman, I want to focus for a moment on the matter of taxation of multinational enterprises by the individual States in the United States. It seems to us that article 9 of the convention strikes a fair and reasonable balance between the various competing considerations which are involved.

As you know, the convention provides the States will not be able to include a portion of the income of a U.K. parent or other related foreign corporation within a State's tax base unless such corporations are actually engaged in business in the United States.

Now, since the Federal Government essentially limits its taxation of foreign corporations to their income derived within the United States, we don't believe that it is unreasonable for the United Kingdom to request a provision in the treaty which prohibits States here from including in their tax base on U.S. corporations doing business in the States an amount greater than that included by the Federal Government.

Consequently, we support the proposed article 9 as an appropriate provision applicable to the U.K. corporations doing business in the United States.

I might say that I think that in the absence of the provision of article 9 of the Tax Convention, and I certainly don't think there should be any effort to seek protocol with regard to that, I would be very fearful frankly that the quid pro quo which is received under article 10 would disappear, and we might have a long, difficult problem ahead of us in trying to reach a Tax Convention with the United Kingdom.

Thank you very much, Mr. Chairman.

Senator CHURCH. Of course, that is a serious matter which the committee must consider if the reservation were attached to the treaty. There are other parts of the treaty that would seem to me to have importance to the United Kingdom, one being the credibility of taxes paid by New York City.

Mr. NORRIS. I think that what I have been getting at is the principal one.

Senator CHURCH. That is a very important provision.

Thank you for your testimony.

Our next witness is Ernest S. Christian, Jr., of Patton, Boggs & Blow on behalf of the Committee on State Taxation of the Council of State Chambers of Commerce.

STATEMENT OF ERNEST S. CHRISTIAN, JR., PATTON, BOGGS & BLOW, ON BEHALF OF THE COMMITTEE ON STATE TAXATION, COUNCIL OF STATE CHAMBERS OF COMMERCE, WASHINGTON, D.C.

Mr. CHRISTIAN. Thank you, Mr. Chairman.

The committee on State taxation consists of approximately 100 U.S. corporations engaged in both multistate business in the United States and international business abroad. This committee has been involved in the study of State taxation for about 10 years. The committee

strongly supports the ratification of the treaty with the United Kingdom.

We have filed with the committee a detailed statement, and I will be very brief in order to leave time for questions. Certainly everyone has made clear that this is a landmark treaty. You are aware of that.

TWO ISSUES

There are two issues.

First, there is a great benefit to the U.S. economy from the imputation and credit in the advance corporation tax. You are familiar with that. Our written statement contains some calculations to which I draw your attention. These show that not only do U.S. shareholders benefit enormously from act, there is a very substantial benefit to the U.S. Treasury as well. One calculation indicates approximately a 20-percent increase by the Treasury on $100 of earnings from U.S. investment abroad. I would recommend that to the committee's attention because it is a very important point.

Second, with respect to article 9(4), the issue is not the unitary formula.

The issue is not the minutia of how it is administered. The issue is really one of the foreign policy of the United States. Again, even with respect to article 9(4), there is a benefit to the U.S. economy.

I would think that it would not be logical for the United Kingdom readily to go forward with the treaty without article 9(4) in it. On the other hand, the United States is not making much of a concession in article 9(4). The United States, including those States which are involved in this narrow version of the formula, would actually benefit from article 9(4). Senator Hayakawa referred to that benefit and, Secretary Woodworth referred to it also.

In our testimony we have given the committee the benefit of some calculations. Any kind of reasonable feedback revenue calculations, such as the Treasury and the Joint Committee staff are now beginning to use for Federal purposes, show that even the location of one or two plants totaling perhaps a billion dollars in the State of California would produce feedback revenues far in excess of the $15 million revenue estimate that California has made as a loss. Not $125 million, but $15 million.

Another reason why the unitary formula is not the question is because the treaty only involves the narrow issue of whether States will tax in this manner foreign corporations owned by foreigners which are not doing business in the United States. The treaty contemplates that the arm's-length standard would, instead, be used. I think Mr. Nolan and others talk about the efficacy of that method in some detail. Certainly, section 482 works very well at the Federal level. It has been a method of great utility at the Federal level for many years. There are no significant problems with it. I do not think Secretary Woodworth has any problems with section 482.

Senator Javits questioned the assertion by another witness that a number of the other States have the unitary concept. Those States are not pertinent to any issue in the treaty.

There are a number of other States, at least 31, who would in some cases apply a type of unitary formula, but not the type of unitary formula that the treaty is dealing with. Those States would under some circumstances treat as "unitary" corporate affiliates which are doing business in that State. But they do not treaty as unitary, or on a combined basis, corporate affiliates which are not doing business in the State and not even in the United States. Thus, the number 31 States and that type of unitary formula is simply not pertinent under the treaty.

In conclusion, conclusion will merely say that there is no basis for questioning the ability of the Congress of the United States to address this problem in a treaty. Certainly, there is ample precedent for it. Indeed, it is the appropriate way to deal with this particular narrow aspect of State taxation of foreign commerce. It is a bilateral issue between countries. There might be other ways of solving this problem but those other ways certainly do not carry with the enormous benefits to the United States from being allowed under the treaty the credit and refund for the act.

There is wisdom in addressing this problem by treaty. If all States, or even a large number of them, began to apply this particular extended version of the unitary formula and began to apply taxes at very high rates to foreign incomes of foreign corporations operating abroad which had an enormous impact on foreign investment in the United States, and that resulted in even greater retaliation or difficulties for U.S. investment abroad, I don't think anyone would suggest that this committee or the Senate should ignore that or should stand aside helpless on the basis that the problem is for the States and not the proper concern of the National Government. Yet, different only in the matter of degree, that it really what the United Kingdom treaty, article 9(4) is addressing itself to. There will be adverse consequences to the U.S. economy broadly, not just involving these few States, unless the Senate moves forward to ratify the treaty. This is in contrast to the very great benefit of the imputation and credit for the U.S. economy as a whole.

Thank you, Mr. Chairman.

[Mr. Christian's prepared statement follows:]

PREPARED STATEMENT OF ERNEST S. CHRISTIAN, JR., ON BEHALF OF COMMITTEE ON STATE TAXATION, COUNCIL OF STATE CHAMBERS OF COMMERCE

Mr. Chairman and Members of the Committee: The Committee on State Taxation ("COST"), Council of State Chambers of Commerce, consists of approximately 100 U.S. companies with income from multi-state and international sources. COST has long been involved in the study of state taxation of international and interstate business transactions. In recent years, through testimony before the tax writing committees of the Congress, as well as studies submitted to the Treasury, COST has contributed importantly to the analysis of the broad issue of state taxation of foreign source income, one aspect of which is reflected in Article 9(4) of the treaty with the United Kingdom now before this Committee for ratification.

This treaty has been carefully worked out by the Treasury over many years, has been strongly supported by two successive Administrations, and should be ratified as promptly as possible.

Two aspects of the treaty are of the most critical importance:

First, Article 10 and 23 (relating to U.K. tax on U.S. shareholders) which is a major concession by the U.K. and which is of major importance to the U.S.; and

Second, Article 9(4) (relating to state taxes) which is a relatively minor concession by the U.S., but which is of major importance to the U.K.

I. ARTICLES 10 AND 23—MAJOR CONCESSIONS BY THE U.K.

Although not directly related to state taxation which is the principal subject of COST's statement, Articles 10 and 23 are intertwined with Article 9(4) in the treaty process of mutual concessions by the Contracting States. Thus, the importance to the U.S. of Articles 10 and 23 must first be discussed.

The U.K. adopted in 1973 an integrated tax system—Advance Corporation Tax—under which when a shareholder receives a dividend he also receives a credit for tax already paid by the corporation. Where the applicable share of corporate tax exceeds the shareholder's tax computed at the shareholder's tax rate, a refund of excess Advance Corporation Tax is paid to the shareholder.

The question is, however, whether the credit and refund for Advance Corporation Tax also will be available to a U.S. shareholder that receives a dividend from a U.K. corporation. The U.K. statute says no. Credit and refund are not under the statute allowed to foreigners Nevertheless, the answer under Articles 10 and 23 of the treaty is yes; a major concession to the U.S. Absent Articles 10 and 23, U.S. shareholders will in effect pay a higher rate of tax on dividends than U.K. shareholders of the same U.K. corporation.

A simple example illustrates substantial benefits both to U.S. shareholders and to the U.S. Treasury. Assume a U.S. corporation owns all the stock of a U.K. subsidiary; the U.K. subsidiary has income of $100, on which a U.K. corporate tax of $52 is due; and the U.K. subsidiary distributes the remaining $48 to the US. shareholder:

Under the existing treaty and U.K. statute, the U.K. allows the U.S. shareholder no credit for the U.K. corporate tax imposed on the subsidiary. The U.S. shareholder ends up with cash in hand of $48 and pays no U.S. tax because the total effective rate of U.K. tax is higher than the 48 percent U.S. rate.

Under the new treaty, the U.K. would allow the U.S. shareholder a credit for a portion of the U.K. corporate tax imposed on the subsidiary, would impose only a 5 percent withholding tax, and would refund the excess of the credit over the withholding tax to the U.S. shareholder. The U.S. shareholder would end up with cash on hand of $58, of which $6 would be payable to the U.S. Treasury because the total effective rate of U.K. tax would be lower than 48 percent.

In this particular example, the new U.K. treaty would mean an additional $4 to the U.S. shareholder and an additional $6 to the U.S. Treasury. Furthermore, the U.K. has argued that it has the right under the existing treaty also to impose a 15 percent withholding tax on dividends, as it did prior to the adoption of the ACT system in 1973. If the U.K. did so, under the existing treaty the U.S. shareholders would receive only $41, which is $11 has than under the new treaty.

The precedent of this concession is of landmark importance. At least 40 percent of U.S. foreign investment is located in countries with integrated tax systems. West Germany, France, and Canada have adopted integrated tax systems which by statute do not allow credit and refund to foreigners. The issue is whether to extend by treaty the credit and refund to U.S. shareholders. The precedent of Articles 10 and 23 will be particularly important in negotiations with Canada. Extension of the credit and refund to U.S. shareholders is among the remaining obstacles to completion of a successful negotiation with Canada.

Failure to obtain ratification by both Contracting States of Articles 10 and 23 in the U.K. treaty might end all hope of obtaining similar provisions in treaties with other countries. The damage would be especially acute if Articles 10 and 23 were lost because of a reservation by the U.S. on Article 9(4) which is the concession by the U.S. most important to the U.K.

II. ARTICLE 9(4)—MINOR CONCESSION BY U.S. BUT IMPORTANT TO U.K.

Although of great importance to the U.K., from a U.S. standpoint Article 9(4) would make only a relatively minor change in the imposition of state taxes on the income of U.K. companies. That change would only affect a handful of states, primarily California. Article 9(4) merely corrects an extraterritorial extension of tax jurisdiction by these states which is doubtful constitutionality, especially when applied to foreign corporations operating outside the U.S.; is

a substantial impediment to investment in the U.S. by foreign nationals; is disruptive of U.S. trade and treaty negotiations; produces unjustified results contrary to the basic framework of state, Federal and international taxation; and results in no net benefit to the states involved.

Considered in that light, it would be difficult to justify refusing to ratify Article 9(4) and at the same time expect to obtain the very important benefits to the U.S. in Articles 10 and 23 of treaty.

California[1] imposes a so-called "unitary formula" state income tax under which it taxes not only the California income of a corporation doing business in California (the basic rule used by other states with income taxes), but also taxes the worldwide income of other corporations affiliated by stock ownership with the corporation in California.

A simplified example, based on an actual case involving a corporation of another country as shown in a survey[2] conducted by COST, is as follows:

A U.K. corporation owned and operated by U.K. citizens solely outside the U.S. bought the stock of a corporation in California which at the time was operating at a substantial loss, but California applied the unitary formula and taxed to the subsidiary (the only corporation it was entitled to tax) the income of the U.K. parent solely from operations in the U.K. A large amount of tax was asserted by California to be due. Thus, the "loss" corporation in California was converted into a major taxpayer.

In this case, California extended its income tax outside the United States and imposed a state income tax on the income of a corporation of another country derived by that corporation solely in that other country. One need only ask what the attitude of the United States would be if a local jurisdiction in the U.K. (or the U.K., itself, for that matter) undertook to tax the income of General Motors from the manufacture and sale of cars in Detroit.

The issue in Article 9(4) of the treaty is not the unitary formula itself, nor the ability of California or other states to apply the unitary formula to U.S. corporations or to U.S.-controlled foreign corporations. Instead, the issue is solely one of the foreign relations of the United States. Article 9(4) would preclude a state from imposing such extraterritorial taxes on corporations of the U.K. (or third countries) which are controlled by residents of the U.K. and which are not doing business in the United States. The remainder of the unitary formula as applied by California or any other state would not be affected by the treaty. Even with respect to the U.K. corporations covered by the treaty, the state would still be able to enforce arm's length standards on all intercompany transfers to assure tax on all income properly attributable to the state.

The narrow limitation in the treaty is clearly a matter of Federal concern and prerogative. There is no invasion of states rights. Federal legislation already restrains state taxation. A good example is P.L. 86–272, relating to state taxation of interstate commerce. U.S. tax treaties uniformly apply the basic nondiscrimination clause to state and local taxes as well as to taxes imposed by the Contracting States. The OECD model treaty applies broadly to state and local taxes. There is ample other precedent for treaty limitations on state taxing powers. See, e.g., *Kolovrat* v. *Oregon*, 366 U.S. 186 (1961); *Clark* v. *Allen*, 331 U.S. 503 (1947); *Nielsen* v. *Johnson*, 279 U.S. 47 (1929); *Missouri* v. *Holland*, 252 U.S. 416 (1920); *Hauenstein* v. *Lynham*, 100 U.S. 483 (1880); *Ware* v. *Hylton*, 3 Dall. (U.S.) 199 (1796); *Scandinavian Airlines System* v. *Los Angeles*, 56 Cal. 2d 11, 363 P.2d 25 (1961).

Article 9(4) is unique only in that special action by the national government is necessary to deal with the marked new departure, by a few states, from the established framework of state and international taxation which interferes with the foreign relations of the U.S.

The treaty is an appropriate mechanism for action by the national Government. In this case, a treaty is required. Among the other methods would be further litigation to establish unconstitutionality and/or legislation at the Federal level as recommended by a Task Force of the Committee on Ways and Means. See recommendations of the Task Force on Foreign Source Income, Committee on Ways and Means, March 8, 1977, pp. 28–30. Those alternatives

[1] Oregon, and possibly Idaho, Montana and Alaska, may also impose the California-type unitary formula in some cases.

[2] This survey was submitted to the members of the Committee on Ways and Means in connection with the work of its Task Force on Foreign Source Income which issued its report on March 8, 1977.

are, however, time consuming. Legislation which COST also supports, involves broader problems. They are best dealt with separately from the narrow problem addressed by the treaty.

The need for Article 9(4), on the other hand, is immediate. Continued uncertainty would exacerbate the interference with the foreign relations of the United States and magnify the distortions involved. It is also not unimportant to consider that in that context of a treaty solution, Article 9(4) carries with it the substantial benefits to the U.S. of Articles 10 and 23; whereas a non-treaty solution likely would not.

A. How Unitary Formula Works: Out of Step with Other States

About 45 states impose taxes. Obviously, they cannot *all* tax *all* the income of a multi-state business. For many years, total income of multi-jurisdiction business has been divided among the states by some version of the three factor formula in the Uniform Division of Income For Tax Purposes Act (UDITPA). The purpose of UDITPA is to apportion to each state where part of the business is conducted the portion of income which is properly attributable to, or from sources within, that state. If no part of the business is conducted in the state, then no part of income should be apportioned to it for tax purposes.

The formula is as follows:

$$\frac{\text{Tangible property, payroll* and sales within the State}}{\text{Total tangible property, payroll and sales within and without the State}} \times \text{Total business income}$$

For example, assume that Corporation X derives $100 of income from its business which encompasses both State A and State B (but no other); and that sixty percent (60 percent) of the property, payroll and sales of that business is in State A and the balance is in State B. The total income is $100 from the business, conducted partly within each state, will be divided between the two states as follows:

State A will tax $60 of the $100 which is in proportion to the percentage of property, payroll and sales located in State A.

State B will apply the same formula and tax $40 of the $100 which is in proportion to the percentage of property, payroll and sales located in State B.

By focusing on the three fundamental ingredients that produce income (property, payroll and sales), the formula is designed to apportion to each state income in proportion to the relative contribution of the economy of that state in producing it.

On the other hand, if instead of only applying the formula to a corporation which is conducting a business partly within the state, and thus deriving income from the economy of the state, the formula is also applied (on a combined basis) to an affiliated corporation which is conducting a business solely outside the state, the result is difficult to defend. That is, however, often the result of the unitary formula and is even less justifiable when the unitary formula is extended still further to include foreign corporations, not doing business in the state, and controlled by foreign residents. It is this latter case to which Article 9(4) of the treaty is directed.

B. Specific Difficulties with Unitary Formula

Apart from the fundamental problem outlined above, additional objections to application of the unitary formula to foreign-controlled corporations are as follows:

1. Penalty Tax Rate. The unitary formula imposes a discriminatorily higher rate of tax on a foreign-owned enterprise conducted in California. That tax increases in proportion to size and profitability of the other operations of affiliated corporations outside the United States.[3] Assume a California based and owned company manufactures and sells boxes in California from which it derives $10 in profit. Assume also, that another company manufactures and sells boxes in California from which it derives $10 in profit, and is identical in every respect except that 50% of its stock is owned by a foreign corporation

*Although expressed here as an aggregate fraction, the practice by most States is to use a separate fraction for each factor and to aggregate the results.

[3] Even though property, payroll and sales of the affiliates outside the U.S. are included in the formula on a combined basis, additional taxes are almost invariably paid.

which manufactures and sells boxes in the U.K. from which a $50 profit is derived. Both companies should pay tax on $10—the income derived from California. But, in fact, the company owned by foreigned may pay tax on 2 or 3 times that amount because part of the income of the U.K. parent corporation is taxed to it in California.

2. Double Tax; Disruption of Treaty Process. The basic principle of all tax treaties between the U.S. and other countries is to avoid double tax.

Normally, no difficulty is encountered with respect to state taxes because both the Federal and state governments tax income of enterprises of the other Contracting State only from sources in the U.S.; and the other Contracting State either allows a credit or does not tax that income. Conversely, we either allow a credit or do not tax income from sources outside the U.S. But when California, for example, undertakes to tax the income of a U.K. enterprise from sources within the U.K., double tax occurs.

3. Discriminatory Non-Uniform Application. In practice, the application of the unitary formula is highly selective and discriminatory. There is no satisfactory definition of which business is "unitary" and which is not. Auditors are left without guidance and the result is often merely to impose the unitary tax where it produces a greater amount of tax. In many instances, the unitary formula—if applied—would result in less tax, as for example, where the foreign-controlled corporation operated at a loss.

While lip service may be paid to a concept of a single "unitary" business or economic unit, combined reporting may be required with respect to affiliated corporations which by any reasonable definition are engaged in separate businesses outside the U.S., have no relationship to the U.S. other than stock ownership, and have no significant intercompany transactions with affiliates doing business in the U.S.

4. Adverse Impact on National Economy. Application of the unitary formula in the manner precluded by the treaty penalizes and, therefore, discourages investment in the U.S. which impacts adversely on the economy and erodes the Federal tax base.

These adverse effects are felt throughout the economy, by citizens of *all* states; whereas any temporary benefits from additional taxes under the unitary formula are obtained only by citizens of a few states, primarily one.

5 Adverse Impact on U.S. Trade and Investment Abroad. Application of the unitary tax to the income of foreign-controlled corporations from sources outside the U.S. invites retaliation against U.S. companies operating abroad, and disrupts U.S. trade and tax negotiations with other countries.

For example, The Special Representative for Trade Negotiations has recently obtained orderly marketing agreements. One contemplates that at least a part of Japanese television sets sold in the U.S. would be from assembly plants to be established in the U.S.—likely located in California. Such Japanese companies, with very large operations through affiliates in Japan and elsewhere outside the U.S., would pay a substantial and, perhaps, prohibitive tax under the unitary formula if they locate a plant in California. This fact may likely frustrate the orderly marketing agreement. See also William Wong, *The Wall Street Journal*, July 12, 1977, p. 1, on efforts by Governor Brown to stimulate investment in California by the Japanese and other foreigners.

6. Disruption of State Tax System. There exists today a carefully worked out and balanced system for apportioning to each state its share of taxable income from a multi-jurisdiction enterprise according to each state's relative contribution to production of that income. The system is founded upon the proposition that all states will adhere to it. The unitary formula applied by a few states radically changes that balance because, in the final analysis, the unitary formula rests on the *new* and insupportable proposition that a state with jurisdiction over one member of a corporate group connected by stock ownership can tax all other members of that group even though the state has made no contribution to the production of their income.

C. Lack of Justification: Only a Revenue Measure

The unitary formula has in the past been sought to be justified on the grounds of administrative necessity and simplicity. It has been asserted, first, that the combined report is only required where a business is a single economic unit partly conducted in California despite the use of separate corporations and, second, that the combined report is necessary to preclude affiliated corporations which make sales to one another from wrongfully pricing intercompany

transfers, and shifting income and expense, so as to deny California its appropriate share of income derived from its economy. Application of the unitary formula cannot be justified on either such basis. As noted above, there is no satisfactory definition of a "unitary" business. The unitary formula is applied to corporations which, by any reasonable definition, are engaged in separate businesses; provided they are affiliated by stock ownership and there is some degree of common management which by definition would exist in nearly all cases.

In those cases, it is not a question of a single economic unit having been artificially divided into two corporations in order to avoid California tax. Instead, it is a case of two separate economic units, one totally unrelated to California, having been artificially combined merely because they are related by stock ownership.

Indeed, if the California law did contain adequate definitions of a "unitary" business and were in fact applied to cases of an artificial division of a single economic unit, it would be far more administratively complex than section 482 of the Internal Revenue Code for which the unitary formula is said by some to be a simpler substitute.

Again, the facts do not support the proposition that the unitary formula is a needed substitute for section 482 of the Internal Revenue Code which identifies and requires intercompany transactions to be carried out on an arm's length basis that does not distort income. The facts are that the unitary formula is applied to affiliates which have little or no intercompany sales. Further, it is applied where all the detailed and strict requirements of section 482 are met and there is not the slightest suggestion that there has been any shifting of income between affiliates—precisely what section 482 is designed to preclude.

Section 482 is a highly refined mechanism, which works well at the Federal level and is fully available to the states. U.S. treaties provide for exchange of tax information on foreign corporations. Section 482 information is available to the states. Early this year the Internal Revenue Service entered into new agreements with 31 states, including California, for exchange of tax information and joint audits.

Thus, as stated above, the rationale of the unitary formula must always come back to the same point: the insupportable proposition that tax jurisdiction over one corporation with a constitutional "nexus" in the state extends to all other corporations affiliated by stock ownership and management, whether or not any part of their business is conducted in the economy of California.

D. Impact on States: Likely to be Positive

A California tax official[4] estimated a revenue loss of about $15 million if Article 9(4) were included in treaties with *all* countries; about one-tenth of 1 percent of total tax collections by tax state. Any revenue loss from the U.K. treaty, alone, would be only a minute fraction of that. This estimated loss should be considered a maximum. It does not take into acount that much or all of such taxes are disputed and may never be collected. The actual revenue loss should be much smaller or nonexistent.

Even this small revenue loss, if indeed it exists, would arise only if computed on a static basis—which ignores secondary economic effects, a process now being modified by the Treasury at the Federal level.

Properly understood, it is easy to see that there would in fact be *no* revenue loss and almost certainly a revenue gain. It has already been demonstrated that the unitary formula imposes a penalty tax on a corporation investing in California if it has a foreign affiliate. This puts such a firm at a competitive disadvantage compared to a corporation already conducting the same business in California that does not have a foreign affiliate. No country in the world imposes a *penalty* on investment from outside; nor should any state, acting reasonably. Internationally, among nations, the problems have been the opposite—"tax sparing" to attract new investment from abroad. New capital investment means economic growth, an increase in the tax base, and greater tax collections. Imposition of a penalty tax under the unitary formula by states has doubtless *cost* those states more in tax collections than has been collected through any apparent gains from applying the unitary formula.

Using California tax rates and assuming a modest rate of return on investment, plus a modest multiplier effect to reflect additional taxes generated from

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[4] Mr. Bruce Walker, Chief Counsel, California Franchise Tax Board.

additional employment, purchases from local suppliers, etc., an additional $1 billion capital investment from one or two new plants in California would at least generate additional tax revenues of $70 to $80 million[5] per year which far exceeds the highest possible revenue collection from applying the unitary formula to foreign-controlled corporations.

While previously apparently ignored, these concerns about the adverse economic impact from applying the unitary formula are now gaining serious attention. The Franchise Tax Board of the State of California held public hearings on this subject on July 12, 1977. See also, *The Wall Street Journal*, July 12, 1977, p. 1.

E. Unitary Formula: Doubtful Constitutionality

There are substantial reasons to doubt the constitutionality of the California-type unitary formula, especially as it applies to a foreign corporation operating outside the United States. Invalidity could be based on at least four separate grounds.

(1) The tax has a potentially adverse effect on foreign relations—a matter reserved solely to the Federal government. That is amply illustrated by the prior discussion of the background leading up to the treaty with the United Kingdom. Because of the inter-relationship between taxation and international trade, such as extraterritorial tax on the foreign source income of a foreign corporation necessarily "affects international relations in a persistent and subtle way"—the criterion applied by the Supreme Court in evaluating the constitutionality of state taxes touching upon international matters. *Zschernig* v. *Miller*, 389 U.S. 429, 440 (1968).

(2) The unitary formula tax is in conflict with at least two established federal policies. First, federal tax policy defers tax on income earned abroad until it is repatriated to the United States. The California-type tax, in contrast, permits no deferral. Second, it is Federal policy to avoid double taxation by techniques such as separate accounting to determine United States source income and deductions or allowances for foreign income taxes. Under a California-type tax, double taxation is virtually certain to occur.

(3) The due process clause and equal protection clause of the Constitution are also offended by the California-type tax. Although California's tax purportedly applies only to a "unitary" business, the term is not defined and there are not statutory standards for determining whether a particular business falls within the concept. Such a lack of standards has often led the Supreme Court to hold a state statute invalid. Erratic application, and treating as "unitary" only applies those foreign subsidiaries whose inclusion in the tax base yields favorable tax consequences for the state, also offends due process.

It is doubtful whether any tax based on an apportionment formula can be constitutional when applied to foreign corporations whose income is earned in foreign countries. The economic underpinnings upon which apportionment rests are lacking in the case of foreign commerce. Any such formula is predicated upon the assumption of a rough equality of economic factors in the taxing state and the other jurisdictions involved. Even as to interstate commerce, any formula used must bear a rational relationship, both on its face and in its application, to property values connected with the taxing State." *Norfolk & Western RC* v. *Missouri Tax Commission*, 390 U.S. 317, 325 (1968). In view of the wide disparities in various countries in the essential ingredients of the apportionment formula, such as differences in property costs, wage rates and prices, it is arguable that as far as foreign commerce is concerned, there is no rational basis for use of an apportionment formula.

(4) Since a California-type tax necessarily exposes foreign commerce to the risk of multiple taxation, it offends the Constitution. At least since the 1930's, the multiple taxation doctrine has been a key to the validiy or invalidity of state taxes under the Commerce Clause. See *Western Livestock* v. *Bureau of Revenue*, 303 U.S. 250 (1938).

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[5] This *conservative* estimate was arrived at by assuming a modest 10 percent pre-tax rate of return, applying the California corporate tax rate of 9 percent to $100 million (10 percent rate of return on a $1 billion investment) and assuming that other categories of tax such as sales, property, etc., increased in the same proportion as the increase in corporate tax revenues. If a more realistic rate of return—such as a 10 percent after-tax rate—were assumed, the feedback revenue gain would be in the range of $150 million annually.

III. CONCLUSION

There is no reason not to ratify the treaty and every reason to do so. Certainly Articles 10 and 23 substantially benefit U.S. shareholders and the U.S. Treasury. Properly understood, Article 9(4)—a reasonable and modest limitation on extraterritorial state taxes—is also beneficial to the U.S. and to the economies of the states directly involved.

Also, it must clearly be understood that the issue in Article 9(4) is *not* the unitary formula nor the principles which underlie it. Certain difficulties with the formula, generally, have been pointed out to illustrate its application. But the issue under the treaty is solely the application of the formula in a narrow area of foreign commerce and trade; not whether one agrees or disagrees with the unitary formula as a general proposition.

Thank you.

[The following information was subsequently supplied:]

PATTON, BOGGS & BLOW,
Washington, D.C., August 3, 1977.

Re Ratification of Proposed Tax Treaty and Protocols With the United Kingdom.

Hon. JOHN SPARKMAN,
Chairman, Committee on Foreign Relations,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This will supplement the statement of the Committee on State Taxation, Council of State Chambers of Commerce, for which I testified on July 20, 1977 in support of the proposed tax treaty and protocols with the United Kingdom. The purpose of this supplement is to correct three erroneous representations in the oral and written statements submitted to the Committee by representatives of the states of California, Oregon and Alaska:

1. The erroneous statement that thirty-one states have adopted the unitary formula of taxation and therefore would be adversely affected by ratification of the treaty;

2. The erroneous statement that the California type of unitary formula which would be affected by the treaty has been approved by the California and United States Supreme Courts; and

3. The erroneous statement that the Task Force on Foreign Source Income of the House Committee on Ways and Means provides support for the application of the unitary formula to foreign affiliates of corporations doing business in the states.

A. Only Five States Apply the California Type of Unitary Formula Which is Affected by the Treaty

The erroneous representation that thirty-one states have adopted the unitary method of taxation "to some degree" and therefore would be adversely affected by ratification of the treaty was made on page four of the written statement of Kenneth Cory, the California State Controller and Chairman of the California Franchise Tax Board, and in his oral testimony. This representation was based on the fact that thirty-one states[1] responded affirmatively to the following question contained in a survey conducted by the State of Indiana in the Fall of 1976: "Are there any situations in which your state goes beyond the corporate shell to consider the unitary corporate business in determining the income tax base? (That is, are there any situations in which your state takes into consideration activities of related corporations in determining the income tax of a corporate taxpayer?)"

Senator Javits asked Mr. Cory to clarify the meaning of his phrase "to some degree" by submitting a chart outlining specifically the extent to which each of the thirty-one states utilizes the unitary formula. The answer should be that the number of thirty-one is impertinent to the Committee's consideration of the treaty. Only five states in fact apply the California-type of unitary for-

[1] Alaska, California, Colorado, District of Columbia, Florida, Georgia, Idaho, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Tennesee, Utah, Virginia, West Virginia and Wisconsin.

mula, whereby foreign affiliates not doing business within the state are required to be included in a combined report. That is the only type of unitary formula affected by the treaty. These five states are California, Oregon, Alaska, Idaho and Montana. The other twenty-six states do not apply a unitary formula in the sense being discussed. In contrast, various of these states may permit consolidated or combined returns which include all corporations joining in the filing of a federal consolidated return with the taxpayer, i.e. domestic affiliates of the taxpayer, but may not require such returns; other states may permit such returns including all corporations filing a federal consolidated return with the taxpayer, but may require such returns only including corporations doing business in the state; and still other states may both permit and require such returns including all corporations joining in a federal consolidated return with the taxpayer, but may only require such returns on the condition that they be necessary to clearly reflect income. Those are entirely different practices which are not involved with the treaty, even indirectly or by implication, and which are not the subject of the controversy.

The combination or consolidation provisions and practices of each state are summarized in the "Compilation of the Manner in Which States Impose Income Taxes on Income From Foreign Sources" submitted by the Committee on State Taxation to the members of the House Committee on Ways and Means in connection with the work of its Task Force on Foreign Source Income, which issued its report on March 8, 1977. The compilation was based on statutory and regulatory source material and was prepared by members of the Committee on State Taxation who were selected for special expertise and experience in the practical application of state income taxes to both domestic and foreign source income.[2] The following state provisions are representative:

1. *Indiana.*—Indiana law contains no provision under which the State may require the filing of consolidated returns. Corporations which constitute an affiliated group under Internal Revenue Code Section 1504[3] and are subject to tax in Indiana may elect to file a consolidated Indiana return.

2. *Florida.*—Florida law contains no provision under which the State may require the filing of consolidated returns. Corporations subject to Florida tax may elect to file consolidated returns with all affiliates subject to Florida tax, and may elect to consolidate with all affiliates even though some are not subject to Florida tax, if the affiliated group files Federal consolidated returns.

3. *Oklahoma.*—A consolidated return may be required only of corporations which file Federal consolidated returns and derive all of their income from Oklahoma sources. Corporations which file a Federal consolidated return and derive part of their income from sources outside Oklahoma may elect, but may not be required, to file Oklahoma consolidated returns.

4. *Kansas.*—Corporations that file Federal consolidated returns may be permitted or required to file consolidated Kansas returns where necessary to clearly reflect the Kansas taxable income of the group; corporations that file Federal consolidated returns must file on a consolidated basis in Kansas if they derive all of their income from Kansas sources.

5. *Tennessee.*—A Tennessee statute enacted in 1976 gives the Commissioner of Revenue authority to require combined reports where necessary to prevent evasion of taxes or clearly reflect income, but only where each member of the group is a U.S. domestic corporation which has its commercial domicile in the United States and carries on a substantial portion of its business in the United States.

6. *West Virginia.*—Consolidated returns are permitted at the taxpayer's option and may be required if the Tax Commissioner determines that intercompany prices or transactions have been artificially arranged to shift taxable income to members of the group not subject to West Virginia tax.

B. The California Type of Unitary Formula Which Would Be Affected by the Treaty Has Not Received Judicial Approval

Mr. Cory claimed on page two of his written statement that "California's method for determining income has been used for over forty years, with the

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[2] The compilation indicates that two states which responded affirmatively to the Indiana survey question, Mississippi and Tennessee, neither permit nor require consolidated or combined reports. Tennessee law on this subject was changed during 1976. Mississippi law and practice, however, have remained the same. Mississippi's affirmative response may have been based on the fact that Mississippi officials have a section 482 type of authority to allocate income and deductions among related corporations which have engaged in non-arm's length transactions.

[3] Section 1504(b)(3) excludes foreign corporations from the term "affiliated group."

approval of the California and United States Supreme Courts in cases involving both domestic and foreign based companies." Mr. Cory does not cite those cases. However, the California type of unitary formula—which would be affected by the treaty to the extent that it requires a foreign corporation doing business in the taxing state to include in a combined report the income of its foreign affiliates, including subsidiaries, not doing business in the taxing state, or a domestic corporation doing business in the taxing state to include in a combined report the income of its foreign non-subsidiary affiliates not doing business in the taxing state—has never been addressed, much less approved, by the U.S. Supreme Court or the California Supreme Court.[4]

The U.S. Supreme Court has never addressed the application of a formula method of apportionment to the income of a corporation not doing business within the taxing state. This presents constitutional questions substantially different from those raised by the application of formula apportionment to the business income of a single corporation operating both within and without the taxing state. The Supreme Court has addressed and approved formula apportionment only in the single corporation context. *Butler Brothers* v. *McColgan*, 315 U.S. 501 (1942); *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 226 U.S. 271 (1924); *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920). Recently the Supreme Court has refused to hear appeals of two state court decisions with respect to the same corporate group. *Kennecott Copper Corp.* v. *State Tax Commission*, 27 Utah 2d 119, 493 P. 2d 632, *appeal dismissed*, 409 U.S. 973 (1972), (approving the use of an apportionment method other than formula apportionment to the combined income of Kennecott and its subsidiaries doing business in Utah); *Chase Brass & Copper Co.* v. *Franchise Tax Board*, 7 Cal. App. 3d 99, 86 Cal. Rptr. 350, *cert. denied*, 400 U.S. 961 (1970) (holding that the business of Chase Brass was unitary with that of its parent, Kennecott Copper, and several of Kennecott's other subsidiaries, some of which were not doing business in California). In the *Chase Brass* decision, a U.S. subsidiary of Kennecott which operated exclusively in a foreign country was excluded from the unitary group. These appeals are not pertinent to the treaty.

Courts in Montana, Oregon, California and Idaho have approved those states' practices—which would not be affected by the treaty—of taxing the combined income of a U.S. corporation operating within the taxing state and its domestic affiliates not doing business in the taxing state. *See Montana Department of Revenue* v. *American Smelting and Refining Co.*, No. 13249 (Mont. S. Ct. July 11, 1977) (domestic subsidiaries); *Edison California Stores* v. *McColgan*, 30 Cal. 2d 472, 183 P. 2d 16 (1947) (domestic parent and other domestic subsidiaries thereof); *Coca Cola Company* v. *Department of Revenue*, 271 Ore. 517, 533 P. 2d 788 (1975) (domestic subsidiaries); *American Smelting and Refining Co.* v. *Idaho State Tax Commission*, No. 53182 (Idaho Dist. Ct., 4th Jud. Dist., Nov. 13, 1975) [Prentice-Hall Idaho State and Local Taxes § 13,053] (domestic subsidiaries). The Montana and Idaho decisions in *American Smelting and Refining Co.*, which arose from the same Multi-state Tax Commission audit, also approved the combination of the income of a U.S. parent operating in the taxing state with that of a foreign subsidiary not doing business in the taxing state—a practice which also would not be affected by the treaty and which presents significantly different questions from practices which would be affected by the treaty, such as including foreign affiliates in combined reports of foreign companies doing business in the taxing state.

C. The Task Force on Foreign Source Income Specifically Rejected Application of the Unitary Formula to Foreign Affiliates

The statements of Mr. Cory (page seven and Attachment 3, page twenty-one), of Theodore W. de Looze, Chief Tax Counsel of the Oregon Department of Justice (page thirteen), and of the National Association of Tax Administrators (pages four through five) erroneously quote the following passage from the report of the Task Force on Foreign Source Income of the House Committee on Ways and Means in support of the application of the unitary formula to foreign affiliates of corporations doing business in the United States:

"This [arm's length] approach already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the

[4] The California State Board of Equalization has held that a foreign parent and the parent's foreign subsidiaries not doing business in California may be included in a combined report of a U.S. corporation operating in California. *Appeal of Beecham, Inc.*, State Board of Equalization (March 2, 1977) [Prentice-Hall California State and Local Taxes ¶ 13,102–I].

State level as applied to interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as disinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of *determining what income of a company is earned within a State as opposed to being earned within other States* (or in foreign countries)" [emphasis added].

This quoted excerpt merely acknowledges the underlying rationale of the apportionment formula when applied to the multi-jurisdiction income of a single company or its affiliates that are doing business in the state. That is not in dispute and is irrelevant to the treaty. What is in dispute, and the subject to which the treaty is directed, is the propriety of applying an apportionment formula to the income of foreign affiliates (not doing business in the state) of a corporation that is doing business in the state. This the Task Force specifically rejected by recommending that "the States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates [not doing business in the state] of corporations doing business within the States until such time as that income is subject to **Federal income tax.**"

D. Conclusion

Thus, we submit that all three representations are in error: it is not correct that thirty-one states have adopted a unitary formula that would be affected by the treaty; it is not correct that the courts have approved the type of unitary formula affected by the treaty; and it is not correct that the report of the Task Force on Foreign Source Income of the House Committee on Ways and Means supports application of the unitary formula to foreign affiliates.

Respectfully submitted.

ERNEST S. CHRISTIAN, Jr.

Senator CHURCH. Thank you Mr. Christian.

EFFECT OF RESERVING ARTICLE 9

Are you really of the opinion that if article 9 were reserved by the Senate that the treaty would fall?

Mr. CHRISTIAN. This provision. Given its background and given the fact of the offsetting benefit to the United States under articles 10 and 23, I would think it would be illogical, at least a matter of great concern, for the United Kingdom whether they would go forward with it.

Senator CHURCH. We have to engage in a bit of guesswork.

Mr. CHRISTIAN. That is certainly true.

Senator CHURCH. Our next panelist is John S. Nolan speaking on behalf of the British National Committee of the International Chamber of Commerce and the Confederation of British Industry.

STATEMENT OF JOHN S. NOLAN, MILLER & CHEVALIER, ON BEHALF OF THE BRITISH NATIONAL COMMITTEE OF THE INTERNATIONAL CHAMBER OF COMMERCE AND THE CONFEDERATION OF BRITISH INDUSTRY, WASHINGTON, D.C.

Mr. NOLAN. Mr. Chairman and members of the committee, I speak for the British National Committee of the International Chamber of Commerce, representing a broad cross section of leading industrial and commercial companies in the United Kingdom.

I am speaking also for the Confederation of British Industry which, through more than 115,000 member and affiliated organizations, represent businesses employing over 10 million persons in Great Britain. This is one-half of total employment in Britain outside of central and local government. We are the principal proponents of article 9(4). We are not special interest groups.

IMPORTANCE AND SOUNDNESS OF ARTICLE 9(4)

We strongly support the treaty. We are here primarily to explain the importance and soundness of Article 9(4). Article 9(4) sets forth a principle which applies long-established, well-accepted international tax principles with respect to taxation by the political subdivisions of either country. It is not an infringement of States rights. It will not operate in fact to prevent California, Oregon, or Alaska from taxing income of United Kingdom corporations or their U.S. subsidiaries which is properly attributable to such States.

You have heard of the immense importance of this treaty to the United States. I would simply like to add that a reservation by the Senate on article 9(4) will seriously jeopardize the existence of this treaty.

The treaty is critically important because for the first time in history the United States has succeeded in obtaining for U.S. direct investors the benefit of one-half of the shareholder credit for the ACT, the British advance corporation tax. The United States was unable to obtain that concession from France in the mid 1960's in negotiating the French treaty at that time. This is important not only because of the great volume of U.S. direct investment in the United Kingdom, but also, as you have heard, because of the precedent that this will have on the treaties with West Germany, France, Denmark, and Canada.

I would add that the ACT credit has a very important effect for the United States. It will increase incentive to U.S. investors to repatriate earnings to the U.S., very substantially to the benefit of the U.S. Government and U.S. public generally. That will increase U.S. tax revenue. I would also add that a large part of the ACT credit in the case of direct investors will itself increase U.S. tax revenues because it will reduce the foreign tax credit of the U.S. companies.

Treaties, of course, by their nature reflect mutual benefits to each country. One of the most important consequences of this proposed treaty to the United Kingdom is the protection which it affords U.S. companies from unreasonable tax burdens resulting from the recent extension by California, Oregon, and Alaska of their use of the unitary business method to foreign-owned controlled groups.

Beginning in the early 1970's these three States for the first time extended their unitary business method to allocate the worldwide income of foreign controlled corporate groups. The reason there have been only 12 requests for relief in the past 10 years or so is that this is a recent extension by those three states of the unitary business concept to allocate the worldwide income of foreign control groups. It is a recent action. It is not the customary application of the unitary business method.

Because this method in the case of foreign controlled groups reached out and takes into account worldwide income, we think it is demonstrably unsound. It does in fact impose unreasonably large state tax burdens on U.S. companies. It also imposes impossible administrative burdens of converting income and financial data all over the world into dollars by U.S. accounting standards.

The United Kingdom corporate groups by their very nature consist of subsidiaries in all parts of the world. That is the nature of the British Empire. They keep their books and their record in different

languages, in different currencies, by different accounting systems. It is virtually impossible to convert all of this information to California standards to comply with the extension of the California unitary business method to foreign-owned corporate groups.

RELATIVE MERITS OF ARM'S-LENGTH AND UNITARY METHODS

I would like to take a minute to consider the relative merits of the arm's-length standard versus the unitary method. The arm's-length standard is, of course, the method used by the U.S. Government in determining Federal taxes and by virtually every other government in the world. We are to compare it to the merits of the unitary business system, which does not attempt to determine actual income earned in a State such as California, but arbitrarily allocates worldwide income based on the fraction of plant, payroll, and sales.

The Federal Government's arm-length standard in section 482 has been misrepresented to this committee by representatives of California as ineffective despite the fact, as I have said, that it is used by the U.S. itself and by virtually every other government in the world. I have practiced law for 26 years in the United States, both in and out of the Government, and in my experience, section 482, the arm's-length standard, while far from perfect, works reasonably well to protect the revenue.

The U.S. Treasury Department has comprehensive regulations implementing section 482 which are emulated by many other governments in the world.

Furthermore, it is quite incorrect to say, as the State tax representatives did here yesterday, that in 40 percent of the cases the arm's-length standard cannot be applied. The Treasury regulations contain a whole series of elaborate rules for determining arm's-length prices when transactions between unrelated parties are not available for comparison.

None of these rules in the regulations use the unitary business method. Furthermore, the U.S. Internal Revenue Service thoroughly audits the affairs of almost every large corporation in the United States, including U.S. subsidiaries of foreign parent companies.

The arm's-length standard is rigidly applied by the IRS and, most important of all, these audit results are fully available to the States under our system whereby the States get the benefit of IRS audits made for Federal tax purposes.

The unitary business concept, on the other hand, is quite arbitrary and frequently quite unfair in its results. You will hear today from Mr. McKee how it operates to allocate profit to California when it is demonstrably clear that California operations in fact result in a loss. You will also hear today from Mr. Reveal how the unitary method operates to allocate profit of a British group of companies too far in excess of actual income from California.

While the unitary business method has considerable justification for allocating income within a homogenous economic system, such as the United States, it is not justified when it reaches out beyond national boundaries and allocates income on the basis of factors that cannot be compared. The average per hour labor rate, for example, in the United States is $6.90, but in Indonesia it is only 50 cents. Profits do not bear a uniform relationship to costs, and the result of dispari-

ties such as these and labor rate differences is that an unreasonably large portion of the worldwide profit is allocated to California which has one of the highest wage rates in the world.

INFRINGEMENT ON STATES RIGHTS TO TAX QUESTIONED

Much was said yesterday that this is an unprecedented infringement on the rights of the States to tax. This is also not correct. In my written statement I have demonstrated that our existing Treaty of Friendship, Commerce and Navigation with France specifically provides that French companies cannot be taxed by our States except with respect to property located in such State, income or profit derived from activities within that State, or business which the French companies do in that State. This is not a nondiscrimination article. It is a direct restriction on the right of the States to tax and, in my judgment, it probably already outlaws the use of the California unitary method as applied to worldwide income of French companies.

Other U.S. treaties have restricted the rights of the States to tax. In *Nielsen* v. *Johnson*, cited on page 21 of my statement, the U.S. Supreme Court held that the United States-Denmark Treaty invalidated the application of an Iowa inheritance tax.

As Dr. Woodworth said yesterday, the United States-Sweden Treaty was applied by the California Supreme Court in the Scandinavian airlines case, also cited in my written statement, to invalidate property taxes on airplanes of a Swedish airline used in the United States.

MR. ULLMAN'S LETTER

We were quite surprised by the letter from Mr. Ullman yesterday to the effect that this matter should be dealt with only by legislation. We note that Mr. Ullman is from Oregon, one of the three States that would be affected by the treaty, and he did not speak for the House Ways and Means Committee.

In any event, his letter overlooks two fundamental considerations. First, the treaty by its nature is a series of mutual concessions as in any contract. The United States has obtained a major concession from the United Kingdom in the form of the ACT credit for direct investors. This is unprecedented.

Article 9(4) has been included in the treaty because it is an important matter of principle to United Kingdom companies. British companies cannot be expected to rely on the possibility that Congress might consider this matter legislatively. As I have summarized in my written statement, the Willis subcommittee spent 10 years in the Congress trying to achieve general uniformity of State taxation without any success. States will vigorously resist any such legislation. I might add that the Willis subcommittee was opposed to the application by the States of the unitary business method insofar as it took into account foreign source income.

RESERVATION WILL JEOPARDIZE TREATY

I would like just one more minute, Mr. Chairman, to make a final point. I would like to say that a reservation will jeopardize the existence of this treaty. It will require that the treaty go back to Parliament

for reconsideration. There is no precedent in the United Kingdom for a treaty going back to Parliament, after it has been once approved by Parliament, because of a reservation by the other government. It was a controversial treaty, and on January 12, 1977, when it was considered by the House of Commons, it is quite evident from the parliamentary debates that article 9(4) was of major importance in securing United Kingdom ratification. If the U.S. reserves on article 9(4), it is entirely possible that the treaty will have to be renegotiated from ground zero.

The United Kingdom concession of one-half of the ACT credit to U.S. direct investors is not popular in the other Common Market countries, particularly West Germany and France, and the results of the renegotiation would be highly uncertain. At the very least the retroactive allowance of the ACT credit to 1973 for portfolio United States investors, and to 1975 for U.S. direct investors, would be seriously jeopardized.

I might add that the U.S. Treasury would suffer in large part because if U.S. direct investors do not obtain the ACT credit, and it is not retroactive, they will obtain a larger foreign tax credit for U.S. taxes unreduced by the ACT credit. We urge that the committee recommend ratification of the treaty without any reservation.

[Mr. Nolan's prepared statement follows:]

PREPARED STATEMENT OF JOHN S. NOLAN ON BEHALF OF THE BRITISH NATIONAL COMMITTEE OF THE INTERNATIONAL CHAMBER OF COMMERCE AND THE CONFEDERATION OF BRITISH INDUSTRY

Mr. Chairman and Members of the Committee: I appear on behalf of the British Chamber of Commerce and the Confederation of British Industry. The British National Committee represents a broad cross-section of leading industrial and commercial companies in the United Kingdom. The Confederation of British Industry directly represents some 14,000 corporate organizations in Great Britain and some 100,000 more through affiliated trade and employer organizations. The Confederation speaks for businesses employing over 10 million persons, one half of total employment in Great Britain outside of central and local government.

SUMMARY

Both organizations strongly support the treaty. I shall direct my remarks particularly to Article 9(4), which would establish reasonable rules with respect to taxation of U.K. corporations and their subsidiaries by States of the United States, particularly with respect to income arising outside of the United States. I will demonstrate that the effect of this provision has been severely overstated by critics as an infringment of States rights. It is not an infringement of States rights. It is a proper exercise of the treaty power under the Constitution of the United States. Article 9(4) sets forth a principle which constitutes a reasonable accommodation of United States and United Kingdom interests, designed only to protect British-owned companies from unreasonable taxation, entirely in accord with international tax concepts and well-accepted tax rules in the United States itself. The provision will not operate in fact to restrict California, Oregon, or Alaska from taxing income of U.K. corporations or their U.S. subsidiaries where such income is properly attributable to such States.

NOTE.—This material is presented by Miller & Chevalier, 1700 Pennsylvania Avenue, N.W., Washington, D.C. 20006, which is registered under the Foreign Agents Registration Act of 1938, as amended, as an agent of the British National Committee of the International Chamber of Commerce, 6–14 Dean Farrar Street, London, SW1H ODT, England, and the Confederation of British Industry, 21 Tothill Street, London, SW1H 9LP, England. This material is filed with the Department of Justice where the required registration statement is available for public inspection. Registration does not indicate approval of the contents of this material by the United States Government.

THE CRITICAL IMPORTANCE OF THIS TREATY TO THE UNITED STATES

Before reaching Article 9(4), the Committee should recognize that this is the most important income tax treaty to come before the Senate in a decade or more. It contains a critical concession by the United Kingdom with respect to the United Kingdom system of integrating U.K. corporate and shareholder income taxes (the imputation or shareholder credit method of avoiding double taxation of corporate income which has been recommended for adoption by all countries in the Common Market). The United States presently has, in advanced stages of negotiation, new income tax treaties with West Germany, France, and Denmark. France and West Germany already have integrated tax systems using the same type of shareholder credit as the United Kingdom. In addition, it is well known that the only remaining unresolved issue in the proposed new treaty of the United States with Canada is an appropriate concession by Canada under its shareholder credit system. If this United Kingdom treaty is ratified, it will be a strong precedent for persuading Canada to make a similar concession to the United States so that that treaty may also be concluded. Similar considerations may apply in the cases of West Germany, France, Denmark, and other countries which adopt an imputation system.

THE UNITED KINGDOM INTEGRATED TAX SYSTEM (ACT CREDIT)

Under the United Kingdom shareholder credit system, upon payment of a dividend, a United Kingdom corporation is required to make a special advance payment of corporation tax based on grossing up the dividend at a basic rate, which is currently 35 percent. The tax payment is 35/65ths of the proposed dividend payment. The tax is paid from the corporation's funds and is not withheld from the dividend paid to the shareholder. This special corporate tax, known as the Advance Corporate Tax or ACT, is then credited against the U.K. corporation's regular corporate income tax, but it is not refundable. Thus, it is in effect a minimum corporate income tax with respect to that portion of corporation income which is distributed as a dividend. The U.K. shareholder then grosses up his dividend, using the same basic rate, and is entitled to a credit for the amount so grossed up, which is set off against his personal tax liability.

Consider a simple example. A U.K. corporation with taxable income of £100 proposes to pay out all of its after-tax income as a dividend. The United Kingdom regular corporate income tax rate is 52 percent, but investment allowances or other special provisions may reduce the regular corporate income tax well below this rate. Assume the regular corporate income tax on the U.K. corporation would be £32. The corporation may declare a dividend of £65 (not £68). This occurs because the dividend amount must be grossed up based on a fraction of 35/65, yielding &35, in lieu of the £32 regulator corporate income tax, leaving it with £65 for the dividend. (Note that the corporation has paid a minimum corporate income tax of £35.) The shareholders then report a dividend of £100, after also grossing up the £65, actual dividend based on a 35 percent rate, and they are entitled to a tax credit of £35. A shareholder with no tax liability would receive a refund of £35. A shareholder in the 70 percent bracket will pay an additional tax of £35.

Under the general U.K. tax law, however, no credit or refund of the ACT is allowed to a nonresident foreign shareholder, whether such foreign shareholder is a corporation or an individual. Therefore, in the absence of a treaty, a foreign shareholder may not recover the ACT as a refund or a credit.

The United States was faced with a similar system in France in its treaty negotiations in the mid-1960's. The United States naturally pressed strongly to have France allow U.S. shareholders in French corporations the same credit (the so-called *avoir fiscal*) to which French shareholders in such corporations were entitled. After extended negotiations, the French allowed U.S. portfolio investors in French corporations the same credit, which could be used against the French withholding tax with the balance refunded. (A "portfolio investor" is a shareholder holding less than a 10 percent interest.) The French refused, however, to allow any credit to U.S. direct investors (persons holding more than a 10 percent interest in the stock of a French corporation.)

In this proposed U.S.-U.K. treaty, however, the United States has succeeded for the first time in history in obtaining for U.S. direct investors in a U.K.

corporation one-half of the credit (in addition to a full credit for U.S. portfolio investors in U.K. corporations). This is a major breakthrough in U.S. tax treaty policy.

This is a major concession by the United Kingdom. The total U.S. direct investment in the United Kingdom at the end of 1975 was $14 billion, the largest in any country in the world except Canada, and it is probably substantially higher at present because of multi-billion dollar investments by U.S. corporation in North Sea drilling operations. It represents more than 10 percent of U.S. direct investments outside the U.S. in the entire world. Thus, the U.K. concession is of great importance to the United States and its citizens. U.S. oil companies have largely discovered and developed the North Sea oil fields, and they will have very substantial income from their U.K. subsidiaries conducting such activities. U.S. automobile companies and other U.S. industries have major investments in the United Kingdom through U.K. subsidiaries. The refunds to U.S. companies and U.S. investors attributable to these ACT credits will run to hundreds of millions of dollars annually.

The United States Government will also benefit from these U.K. tax reductions to the extent that the U.K. taxes otherwise payable would have been available as foreign tax credits for U.S. direct investors, thus reducing U.S. tax liabilities. This is well illustrated by Marianna Burge, formerly associated with the U.K. Inland Revenue, in the Journal of Taxation (44 J. Tax 296, May, 1976).

When the proposed treaty was debated by the U.K. House of Commons on January 12, 1977, one Member of Parliament, Mr. Hordern, indicated that there were about 2000 subsidiaries of U.S. corporations in the United Kingdom with a book value of about £5 billion. He noted that their investment in 1976 had greatly increased in the last three years. Emphasis was laid on the fact that there would be an incentive to increase the rate of distributions to the United States because of the ACT element. It was noted that the amount of cash that can be reclaimed increases with the amount of distribution. Mr. Hordern also stated that the U.K. Treasury estimated that the outflow of interest, profits, and dividends from North Sea operations would be £750 million in 1977, £1250 million in 1979, and £1750 million in 1980. Another members, Mr. Clemitson, expressed concern that the treaty might induce U.K. subsidiaries of U.S. corporations to distribute profits to the United States, rather than reinvest them in the United Kingdom.

ALLOWANCE OF ALLOCATED DEDUCTIONS

There is another important article in this treaty which endorses and clarifies a principle which is of great importance to U.S. companies. In January, 1977, the U.S. Treasury Department adopted the highly-controversial section 861 regulations, the result of which is to reduce the foreign tax credit of many U.S. companies with extensive overseas operations. This occurs because, under these new regulations, the amount of deductions allocable to foreign source income is substantially increased; the consequent reduction in foreign source taxable income for U.S. tax purposes reduces the portion of the U.S. tax which may be offset by the foreign tax credit. In the proposed treaty, the United Kingdom commits itself, in varying degrees, to allow increased amounts of such deductions in determining U.K. tax liability. To the extent this occurs, U.S. companies are not hurt by the increased allocation of deductions to foreign source income and the resulting potential increase in their U.S. tax liabilities. This increase is offset because their U.K. tax liabilities are proportionately reduced.

The provisions are contained in Articles 7(3) and 24(3) of the proposed treaty. Under Article 7(3), the United Kingdom is required to allow to a U.K. branch of a U.S. corporation, in determining its U.S. tax, a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses—incurred for the purposes of the enterprise as a whole * * *, whether incurred in the State in which the permanent establishment is situated or elsewhere.

This represents a major assistance to U.S. companies. It should go a long way in alleviating the double taxation that could arise by reason of the controversial action taken by the U.S. Treasury Department in adopting these new regulations.

Article 24(3) contains a provision possibly even of greater significance. The United Kingdom has agreed to permit deductions of a similiar nature in determining the tax of one of its own corporations in respect of certain payments by that corporation to its U.S. parent corporation. This is a condition, however, that such payments are deductible only to the extent they would be deductible if paid to a resident of the United Kingdom. Nonetheless, by providing for deductions to a U.K. subsidiary of a U.S. parent company for payment of a proper amount of royalties, interest, and administrative expense, the treaty goes a long way in protecting U.S. companies from double taxation.

IMPORTANCE OF THE TREATY TO THE UNITED KINGDOM

There would, of course, also be important consequences to U.K. companies from the treaty. One of the more important is the protection of U.K. companies from unreasonable tax consequences afforded by Article 9(4). While this provision applies reciprocally both to the United States and to the United Kingdom (including the political subdivisions of each), it is prompted by recent action by California, Oregon, and Alaska. This recent action consisted of extending their unitary business method of taxation to take into account worldwide income of foreign-controlled corporate groups, including income of members of such groups which have no connection with such States. Article 9(4) is an entirely proper provision in the treaty; it does not improperly interfere with the California-type unitary business method, and the limitations it does impose are completely in accord with international tax principles and U.S. Federal tax concepts.

THE CALIFORNIA-TYPE UNITARY METHOD

For many years, various States of the United States have determined the income of a corporation by allocating its total income on the basis of the relative dollar amount of property, payroll, and sales in such States to total property, payroll, and sales of such corporation. Beginning in the 1950's, California adopted a "unitary" concept with respect to U.S. corporations whereby the total income of all members of a U.S. corporate group connected by more than 50 percent stock ownership was allocated on this basis, including income of the U.S. corporate group from foreign sources. The rationale was that if unity of business operations exists within the group (central purchasing, advertising, accounting, or management), the necessity of monitoring intercompany transactions between members of the group could be avoided by an arbitrary allocation under the unitary business concept.

Beginning in the early 1970's, California sought to extend its unitary business concept to include the foreign parent of a U.S. subsidiary of a foreign-controlled corporate group and all members of such a foreign-controlled corporate group throughout the world. As a result, California sought to allocate the worldwide income of a foreign-controlled corporate group, including income of members which did no business in California and had no connection with California. Oregon and Alaska have simply followed California's lead in more recent years.

Furthermore, while giving lip service to the concept that there must be more than mere unity of ownership (50 percent or more common ownership within the group), California as a practical matter has all but abandoned the concept that there must be unity of operation as well. Recent actions by the California tax authorities make this clear; California attempts to apply the unitary business method to every foreign-controlled corporate group, any member of which is doing business in California, even though other members of the group have no relationship to California. California has, in effect, abandoned whatever rationale exists for the unitary business method in these cases. In a speech in June, 1974, the former Counsel of the California Franchise Tax Board, Frank M. Keesling, who takes a large measure of credit for instituting in California the apportionment of income under the unitary business concept, made the following statement:

"Now that I am older if no wiser, I question whether there is such a thing as a non-unitary business. Although I still believe that it is appropriate to compute non-business income separately and to allocate it specifically, I am inclined to the view that all income from commonly-owned business activities should be combined and apportioned by a single formula without inquiring as to whether such activities are unitary or separate in nature. Such a policy is simple to administer and will promote uniformity."

The U.S. Federal tax system does not employ the unitary concept. Intercompany dealings are monitored by an arm's length standard (section 482 of the U.S. Internal Revenue Code) which is perhaps the most highly-developed and refined system in the world. International tax principles also are almost uniformly based on the arm's length standard for intercompany dealings, rejecting the unitary concept. This proposed U.S.-U.K. treaty in Article 9(1), and many other U.S. income tax treaties, also set forth the arm's length standard for intercompany dealings.

This newly-developed practice of California, Oregon, and Alaska has been met with astonishment and uniform objection and resentment by foreign-controlled corporate groups with U.S. business operations. This occurs because the effects of the California unitary business method are so extreme in overstating income of foreign-owned corporate groups allocated to California, because the California unitary business method imposes such unreasonable (even impossible) administrative burdens on U.K. worldwide groups in determining and stating "income" by California standards, and because it is so contrary to international tax principles.

CALIFORNIA'S POWER NOT SIGNIFICANTLY AFFECTED BY THE TREATY

Article 9(4) is carefully limited so as to protect only British-owned industry against unreasonable taxation by the United States or its political subdivisions. Unfortunately, its effect has been grossly misrepresented, and it may be the most misunderstood provision in any treaty to come before this Committee in recent years.

There is no unreasonable infringement on the power of California or any other State to tax. The treaty relates only to foreign income of a U.K. corporation controlled by U.K. persons, or a U S. subsidiary of such a U.K. corporation. Even then (using California as an example), it does not exclude from California's tax base the U.S. or foreign income of such a U.K. parent or its subsidiary if they are doing business in California. Furthermore, it does not in any way affect the right of California to tax U.S. corporations or their subsidiaries on any basis they choose, including by reference to worldwide income, even U.K. corporations controlled by U.S. persons.

In short, Article 9(4) will still permit California to take into account all U.S. and foreign income of a corporation doing business in California, whether a U.K. or U.S. corporation, in allocating a portion of such total income to California. In more concrete terms, California may still take into account all U.S. and foreign income of a U.S. subsidiary of a U.K. parent, and all U.S. and foreign income of subsidiaries of the U.S. subsidiary, domestic or foreign. Article 9(4) merely prevents California from taking into account income of other members of a U.K. controlled group, doing business in the United Kingdom or third countries and not in California. California has no need to include such foreign income in its tax base to any extent.

While there may be some theoretical justification for the unitary approach with respect to income earned within a homogenous economic system, such as the United States, the unitary concept begins to lose whatever integrity it has when foreign income arising in different economic systems is taken into account. It surely loses its integrity when it reaches out and takes into consideration, as the California system does, the income of a foreign parent of a U.S. subsidiary doing business in California when that foreign parent does no business in, and has no connection with, California. It becomes particularly arbitrary and unreasonable when it takes into account, as does the California system, the income of a foreign-based group from all over the world, including income of separate corporations which may be only 51 percent owned, which have absolutely no connection with the United States, and which may be operating in totally different economic and social systems which cannot be compared to operations in the United States. The result, in fact, is that California thereby collects taxes based on foreign income in contravention of well-established international standards of taxation, inconsistent even with the manner in which the United States itself determines income subject to tax.

Under section 882(b) of the Internal Revenue Code, the general rule is to tax only the income of a foreign corporation from sources within the United States; in a very rare case certain limited amounts of income from sources without the United States are included (section 864(c)(4)), but only if the

foreign corporation has fixed place of business in the United States to which such income is attributable. In limited circumstances the United States Government imputes income, as though it were a constructive dividend, of a foreign corporation to its U.S. shareholders, but these are special situations (sections 951, 551, 1246, 1248) in which the foreign income is taxed to the U.S. shareholders based on their citizenship or residence in the United States. In none of these cases does the Federal Government include in income more than the U.S. shareholder's ratable share of the corporation's income.

The U.S. Internal Revenue Service itself has recognized that a unitary system of the California type results in taxation of foreign income by the States. The IRS treats the portion of the State income tax allocable to foreign income, thereby reducing the maximum allocatable foreign tax credit. Reg. section 1.861–8(g), example 25.

The widespread opposition that has developed to this latest California development throughout the world, not merely in the United Kingdom, has caused even California to re-think the validity of its unitary method as applied to foreign-based and foreign-owned multi-corporate groups (see infra pp. 42–44).

Before examining the California unitary method in more detail, it is worthwhile to catalogue specifically what Article 9(4) will do and what it will not do. The following propositions are unassailable.

1. California may continue to take into account all domestic and foreign income of multi-corporate groups controlled by U.S. persons, even U.K. companies controlled by U.S. persons, including domestic and foreign income of all subsidiaries (foreign or domestic) in such groups.

2. California may continue to take into account all domestic and foreign income of a U.S. subsidiary of a U.K. parent (even when controlled by U.K. persons), where such subsidiary is doing business in California, including all domestic and foreign income of subsidiaries (foreign or domestic) of such U.S. subsidiary.

3. California may continue to take into account all domestic and foreign income of a U.K. corporation doing business in California (even where controlled by U.K. persons), whether such U.K. corporation is a parent of a worldwide group or not.

4. California may continue to take into account all domestic and foreign income of corporations of third countries unless affiliated with a U.K. parent controlled by U.K. persons. This includes the entire world.

5. California is free even when the limitations of Article 9(4) are applicable, to reallocate under section 24725 of the California tax law any income, deductions, credits, or allowances between a U.K. company doing business in California, or its U.S. subsidiary doing business there, and any other related company in the world to achieve results which would have obtained in arm's length dealings (i.e., the principles of section 482 of the U.S. Internal Revenue Code).

It is apparent that this treaty would limit the power of California to tax only in very specific respects, and only with regard to the most extreme applications of the unitary business concept.

UNITARY BUSINESS CONCEPT CONTRARY TO U.S. FEDERAL AND INTERNATIONAL TAX PRINCIPLES

The United States itself does not find it necessary to divide income between the United States and foreign countries by such an arbitrary apportionment formula. Instead, the U.S. Government's rules for insuring fair allocation of income of related members of a corporate group under section 482 of the Internal Revenue Code have worked successfully, and the Internal Revenue Service vigorously applies this arm's length standard. Substantially every U.S. company with substantial foreign operations is audited by the U.S. Internal Revenue Service. The results of this monitoring are fully available to California under the U.S. system whereby States of the United States may compare income reported to them with income reported to the Federal Government and obtain the complete details of Internal Revenue Service adjustments.

Furthermore, the unitary concept is contrary to well-established international tax principles. An all-embracing principle of the arm's length standard, instead of the unitary concept, was embodied in the model income tax convention of the Organization for Economic Cooperation and Development (OECD), which consists of the principal countries of the world, including the United States, the United Kingdom, France, West Germany, other West Euro-

pean nations, Canada, Australia, and Japan. The OECD model treaty specifically applies this rule to subsidiary levels of government. The 1974 Guidelines for Tax Treaties Between Developed and Developing Countries, prepared under the auspices of the United Nations, adopt the same principle. The United States itself has adopted the arm's length standard uniformly as the basic principle for monitoring intercompany relationships for purposes of income taxation by each of the contracting nations in each of its thirty-seven bilateral income tax treaties not presently in force.

As stated above, California is left entirely free by the proposed treaty to make section 482-type adjustments, and thus California would not be prejudiced by this treaty in determining the income of a U.K. company or U.S. company doing business in California (including income of all U.S. and foreign subsidiaries of any such company). California could insure arm's length results as to any dealings between any such company and its subsidiaries and other members of the U.S. controlled corporate group. The United States had round this latter monitoring to be sufficient; surely California does not require more.

NO INFRINGEMENT OF STATES RIGHTS WILL OCCUR

The purpose of income tax treaties is to foster international trade and investment, which assures competition, promotes efficiency of production and distribution, and results in lower prices and wider opportunities for obtaining goods and services among persons of all nations. This objective is particularly important as between the United States and the United Kingdom which traditionally have been two of the largest trading partners in the world. As previously stated, the volume of foreign direct investment by the United States in the United Kingdom is $14 billion, second only to Canada in the world. The United Kingdom has foreign direct investment of $6.7 billion in the United States and is the largest foreign investor in the United States, outranking even Canada. United States exports to the European Economic Community (Common Market) for 1976 were $25 billion; imports from the Common Market were $18 billion, resulting in a trade surplus of $7 billion. Our largest trading partner in the Common Market is, of course, the United Kingdom.

The United States Constitution delegates to the Federal Government the power to regulate commerce with foreign nations (Art. 1, Sec. 8, Cl. 3), and this carries with it a requirement that no State may place an undue burden on foreign commerce by taxation. In *Philadelphia Etc. Mail Steamship Co.* v. *Pennsylvania*, 122 U.S. 326, 7 S.Ct. 1118 (1887), the U.S. Supreme Court held that a State tax on gross receipts derived by a steamship company from the transportation of persons and property between different States, and to and from foreign countries, was an improper regulation of interstate and foreign commerce. The Court said (page 345):

"The corporate franchises, the property, the business, the income of corporations created by a State may undoubtedly be taxed by the State; but in imposing such taxes, care should be taken not to intefere with or hamper, directly or by indirection, interstate or foreign commerce, or any other matter *exclusively within the jurisdiction of the Federal Government*. This is a principle so often announced by the courts, and especially this court, that it may be received as an axiom of our constitutional jurisprudence." (Emphasis added.)

Under the Constitution, treaties are the supreme law of the land, binding upon the courts of every State (Art. VI, Cl. 2). Only the President of the United States has the power, by and with the advice and consent of the Senate, to make treaties (Art. II, Sec. 2, Cl. 2). The California courts themselves have recognized that U.S. tax treaties may, and in fact do, limit the scope of a State's taxing power. In *Scandinavian Airlines System* v. *Los Angeles*, 52 Cal. 2d 11, 363 P.2d 25 (1961), the California Supreme Court held that the United States-Sweden tax treaty of March 23, 1939 (TS 958, 54 Stat. 1759), precluded property taxation of airplanes of a Swedish airline used in Los Angeles but registered in Sweden. The Court held an apportioned ad valorem tax invalid. The Court acknowledged that: (treaties) are equally binding on the states. * * * If the tax hereunder is repugnant to the terms of any such treaty, the tax must be declared invalid." The United States Supreme Court has held many times that the interests of the States must bow to the larger interests of the United States reflected in treaties, and that a treaty may override the power of a State. *Kolovrat* v. *Oregon*, 366 U.S. 187, 81 S.Ct.

922 (1961); *Missouri* v. *Holland*, 252 U.S. 416, 40 S.Ct. 382 (1920); *Hauenstein* v. *Lynham*, 100 U.S. 483, 25 L.Ed. 628 (1880); *Ware* v. *Hylton*, 3 U.S. (3 Dall.) 199, 1 L.Ed. 568 (1796).

The power of the Federal Government to make treaties is no infringement on the power of any State, because no State ever had such a power. In *United States* v. *Curtiss-Wright Export Corporation*, 299 U.S. 304, 57 S.Ct. (1936), the Supreme Court stated:

"* * * The broad statement that the Federal government can exercise no powers except those specifically enumerated in the Constitution, and such implied powers as are necessary and proper to carry into effect the enumerated powers, it is categorically true only in respect of our internal affairs. In that field, the primary purpose of the Constitution was to carve from the general mass of legislative powers then possessed by the states such portions as it was thought desirable to vest in the Federal government, leaving those not included in the enumeration still in the states. * * * That this doctrine applies only to powers which the states had, is self-evident. And since the states severally never possessed international powers, such powers could not have been carved from the mass of state powers but obviously were transmitted to the United States from some other source. During the colonial period, those powers were possessed exclusively by and were entirely under the control of the Crown.* * *

"As a result of the separation from Great Britain by the colonies, acting as a unit, the powers of external sovereignty passed from the Crown not to the colonies severally, but to the colonies in their collective and corporate capacity as the United States of America. * * *"

The treaty power of the Federal Government is extremely broad—it extends to all subjects which may effect international relationships between the U.S. Government and foreign governments, including trade. See *De Geofroy* v. *Riggs*, 133 U.S. 258, 10 S.Ct. 295 (1890). The treaty power surely extends to placing some limitations on the power of a State to prevent allocation to that State of income of related enterprises resident in the foreign country or third countries where such related enterprises are not doing business in such State and are not controlled by a corporation doing business in such State. In *Holmes* v. *Jennison*, 14 Pet. (U.S.) 540, 569, 10 L.Ed. 579, 593 (1940), it was noted:

"The power to make treaties was designed to include all those subjects which in the ordinary intercourse of nations had usually been made subjects of negotiation and treaty, and which are consistent with the nature of our institutions, and the distribution of powers between the general and state governments."

Treaties have frequently affected stated laws governing inheritance of property. *Kolovrat* v. *Oregon*, supra; *Clark* v. *Allen*, 331 U.S. 503, 67 S.Ct. 1431 (1947). Moreover, in *Nielsen* v. *Johnson*, 279 U.S. 47, 49 S.Ct. 223 (1929), the Supreme Court held that the United States-Denmark treaty required that a proposed application of the Iowa inheritance tax be held invalid because the effect would be to discriminate against non-resident aliens. The Court assumed without question that it was appropriate for such a treaty to limit the extent to which Iowa inheritance taxes could be applied to transfers of intangible property to a Danish resident.

The scope of the States' taxing powers has been traditionally limited in many other ways as required by international considerations. Our treaties almost universally include non-discrimination articles preventing taxation by either country or its political subdivisions of residents of the other country on a basis less favorable than its own residents.

Examples of these nondiscrimination provisions may be found in paragraph 7, as amended, of the Protocol to the treaty with Sweden of March 23, 1939, and in Article XXI (1) and (5) of the treaty with the United Kingdom of April 6, 1945. These provisions specifically provide that the nondiscrimination provision applies to taxes of every kind or description, whether Federal, State, or municipal. In S. Rep. No. 6, 79th Cong., on the treaty of 1945 (TIAS 1546, 60 Stat. 1377) with the United Kingdom the following statement is made on page 15:

"This article [Art. XXI] is in principle identical with paragraph 12 of the protocol to the Canadian convention, paragraph 7 of the protocol to the Swedish convention, and to paragraph V of the protocol to the French convention. It is, however, more elaborately drawn in order to bring within its scope British subjects residing in areas to which the convention is applicable and United States citizens residing in areas to which the convention is applicable and ex-

tension to juridical persons. It will be observed that this article extends to all taxes, both Federal and local. Such extension, however, is in keeping with several commercial treaties (such as that with Norway, of 1928, and that with Germany, of 1923) to which the United States is now a party. It has no practical effect, since our domestic taxation does not discriminate as between United States citizens and British nationals residing in the United States."

The two commercial treaties referred to immediately above were the treaties of Friendship, Commerce, and Consular Rights between the United States and Germany, signed December 8, 1923 (TS 725, 44 Stat. 2132), and with the Kingdom of Norway, signed June 25, 1928 (TS 852, 47 Stat. 2135). Article I of each of these treaties provides that nationals of either High Contracting Party within the territories of the other shall not be subject to the payment of any internal charges or taxes other or higher than those that are exacted of and paid by its nationals.

The Convention of Establishment between the United States and France, signed November 25, 1959 (TIAS 4625, 11 UST 2398), is of greater significance, however. Article XV, paragraph 1, provides that, in the case of the United States, the convention applies to all territories under the sovereignty or authority thereof. Obviously, this makes the convention applicable to all of the States of the Union. Article IX, paragraph 1, provides, in part, that nationals of either High Contracting Party residing within the territories of the other shall not be subject to any form of taxation [of whatever nature or denomination] or any obligation relating thereto, within the territories of such other party, which is more burdensome than that to which nationals of such other Party in the same situation are or may be subject.

More significantly, however, Article IX, paragraph 4, contains the following restriction on taxation by the fifty States, including California. It provides that companies of either High Contracting Party engaged in trade or other gainful pursuit within the territories of the other—"shall not be subject, within the territories of the other High Contracting Party, to any form of taxation upon capital, income, profits or any other basis, except by reason of the property which they possess within those territories, the income and profits derived from sources therein, the business in which they are engaged, the transactions which they accomplish there, or any other bases of taxation directly related to their activities within those territories."

It would seem a foregone conclusion that not only California, but every other State, is thereby precluded from applying the unitary business concept to take into account foreign source income of French corporations having no business office or business connection with the State. If the States are so restricted by this treaty in the application of the unitary business concept to French corporations engaged in business herein, they are surely restricted in applying the concept to affiliated French corporations operating abroad.

FEDERAL LEGISLATION AGAINST FOREIGN EXTRATERRITORIAL TAXATION

The converse of the unitary business concept in modified form was applied by France against U.S. corporations in the 1920's. Taking the position that a French subsidiary corporation was the emanation pure and simple of its foreign parent corporation, France was assessing tax on dividends paid by the foreign parent corporation in the proportion that its assets in France bore to total assets. When efforts were made to persuade the French to desist, the French insisted on negotiating a bilateral treaty with reciprocal concessions, thereby establishing a precedent for negotiations with other governments. The treaty was signed on April 27, 1932 (TS 885, 49 Stat. 3145, XIV–2, C. B. 535). It provided that any profits diverted from the French subsidiary to the American parent would be included in the taxable profits of the French subsidiary and also treated as a taxable dividend. In the case of a French branch of a U.S. corporation, any profits that were diverted to the home office would be subject to French tax as industrial or commercial profits; in addition, three-fourths of these profits would be subject to tax by France as a dividend.

When France delayed in ratifying the treaty of 1932, the U.S. Congress adopted section 103 of the Revenue Act of 1934 (now section 891 of the 1954 Code). It was in effect a retaliation by the United States against France for the extraterritorial tax France had been assessing against U.S. corporations and should serve to demonstrate the type of measure that is available to foreign countries to use in retaliation against the United States for its failure to

eliminate or control, as a matter of international tax policy, the extraterritorial assessments of California and other States using the Unitary Business Doctrine against foreign nationals.

Section 103 of the 1934 Act, which was approved on May 10, 1934, provided that, whenever the President finds that U.S. citizens or corporations are subjected to discriminatory or extraterritorial taxes by a foreign country, citizens or corporations of that country are, pursuant to his proclamation, to be subjected to U.S. taxes at double the rate ordinarily applicable. The House bill on the 1934 Act was leveled only against foreign discriminatory taxes. The Senate extended the provision of extraterritorial taxes and made the following comment in S. Rep. No. 558, 73d Cong., 1939–1, (Part 1) C. B. 586, 610:

"In the first place, the section is made to apply if the foreign country levies extraterritorial taxes, as well as discriminatory taxes. Thus, a tax on income not properly within the jurisdiction of the foreign country imposing such tax will come within this classification. In the second place, the rate of tax is increased from 50 per cent to 100 per cent. It appears that a 50 per cent increase will be only an idle threat in some cases, due to the high taxes imposed by some foreign countries upon American citizens. However, to prevent actual confiscation of the foreigner's income, it is provided that this section shall not operate to increase the rate of tax imposed by other sections of the bill to an amount in excess of 80 per cent of the taxpayer's net income. * * *"

This new provision of law was called to the attention of the French, who were thereby persuaded to ratify the 1932 treaty on April 8, 1935. Not long after the United States had prevailed upon France by this treaty to give up its extraterritorial taxes, the Canadians persuaded the Federal Government, in Article XII of the treaty of March 4, 1942 (TS 983, 56 Stat. 1399), to give up the alleged extraterritorial taxes of the United States imposed upon dividends and interest paid by a Canadian corporation. This alleged extraterritorial tax arises by reason of section 861(a)(1)(C) and 861(a)(2)(B) of the Code and their predecessor provisions. An exemption corresponding to that agreed to by the United States in such treaty with Canada was thereafter agreed to by the United States in many subsequent tax treaties with other countries.

The foregoing discussion, the background of which was given by Mitchell B. Carroll in International Lawyer, Vol. 3, No. 1, demonstrates that the United States has already adopted legislation in retaliation against extraterritorial taxation by a foreign government. The provisions of section 891, and the somewhat similar provisions of section 896 as added by section 105(b) of the Foreign Investors Tax Act of 1966, (Pub. L. 89–809), may still be used by the United States against a foreign country. However, the mutual and reciprocal approach used in Article 9(4) of the pending treaty is by far the more desirable technique of approaching difficulties of this type.

The reciprocal effect of Article 9(4) provides important protection to U.S. companies which may be achieved only by treaties. The only way a U.S. company can be protected against the use of the unitary business concept, whereby income arising outside the taxing country is taken into account in allocation of income to that country, is by use of the treaty power of the United States Government. No State of the United States is capable of obtaining his concession from a foreign government which might undertake the use of such a concept of its own, as was done by France in the 1930's. Article 9(4) is not a unilateral concession by the United States; it is a reciprocal guarantee by the United Kingdom that it will never invoke such a principle against a U.S. corporation and its affiliated corporations, one of which establishes a place of business in the United Kingdom.

OBJECTIONS TO UNITARY METHOD APPLICATION TO FOREIGN INCOME OF U.K. CORPORATE GROUP

There may be some theoretical merit to the use of the unitary business method to allocate income realized within a homogenous economic structure, such as its application with respect to all income from U.S. operations. It is not justified, however, where it allocates differing kinds of foreign income realized by a foreign-based group of corporations from all over the world. The Foreign Source Income Task Force of the House Ways and Means Committee, after thorough study of the subject, concluded that the States should be precluded—"* * * from taking into account, under the unitary method or any other method, the

income of foreign affiliates of corporations doing business within the States until such time as that income is subject to Federal income tax."[1]

This limitation, of course, would be entirely consistent with Article 9(4) of the proposed U.S.-U.K. treaty; California could not take into account the income of a U.K. parent not doing business in California (unless controlled by U.S. persons), or income of affiliates of such U.K. parent not doing business in California, since this income is not subject to Federal tax. California could, however, take into account the foreign income of a U.S. subsidiary of such a U.K. group, or even the U.K. parent itself if it were doing business in California, at the time such foreign income became subject to U.S. Federal tax.

There are two fundamental reasons why the unitary method should not be applied with respect to income of a U.K. parent or affiliated companies in third countries where such parent or affiliated companies are not doing business in the United States. First, such a foreign-owned and foreign-based corporate group is likely to have operations all over the world, in both developed and developing countries. Most or all of the U.K. groups with U.S. subsidiaries doing business in California, which would be the only companies affected by Article 9(4), fall into this class. The United Kingdom historically has depended upon world trade, and U.K. businesses traditionally reach into every corner of the world as an outgrowth of the former size of the British Empire itself.

This means that a unitary method based on income from all such operations will necessarily allocate or apportion income based on payroll amounts, property costs, and sales which cannot fairly be compared. The result is to allocate a higher portion of total income to the location where these amounts are highest, relatively speaking, unless income bears the same relationship to cost throughout the world irrespective of the amount of such costs. As compared to the United States, profit margins vary widely throughout the world and bear no such uniform relationship to costs.

The California system creates major distortions which tend to result in over-allocations of income to that State. California wages per hour are generally much higher than elsewhere in the world,[2] and even after allowance for capital intensity and productivity, the payroll factor tends to over-allocate income to California. California has refused to reduce the extent of this distortion by applying the payroll factor in terms of hours rather than dollar wages. California uses only payroll dollars in the payroll factor, excluding pension and other fringe benefit costs. These other labor costs are often higher in foreign countries with more extensive social programs than the United States; exclusion of these costs often over-allocates income to California.

Property costs are also substantially higher in California than elsewhere in the world, with the same distortive effect because of the application of the property factor. California also has stringent pollution control requirements, causing a relatively higher property investment per unit of production in that State without an equivalent increase in profits; in fact, such non-productive property costs may reduce actual California profits. Again, the property factor thereby tends to over-allocate worldwide income to California.

Even the sales factor causes major distortions when income arising outside a homogenous economic system is allocated. For example, B.A.T. Industries, a U.K. corporate group with extensive world-wide operations, has a U.S. subsidiary, Brown and Williamson Tobacco Company. The heavy U.S. Federal and State tobacco excise taxes are reflected in U.S. sales, without any proportionate increase in profit margins, causing an over-allocation of world-wide income to California pursuant to the sales factor.

California ignores demonstrable differences in the relationship of profits to sales, also tending in some cases to over-allocate income to California. For example, Rickett & Colman Limited, a U.K.-controlled group, has diverse business activities all over the world. Its U.S. activities are limited almost entirely to its food and wine operations, which represent 44.4 percent of total group sales but only 30.3 percent of operating profits. The group's household and

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[1] Recommendations of the Task Force on Foreign Source Income, Committee on Ways and Means, U.S. House of Representatives, 95th Cong., 1st Sess. (March 8, 1977).

[2] Comparative per hour wage rates in dollars in 1976 were as follows in the countries indicated: U.S.—$6.90; U.K.—$3.05; France—$4.95; Japan—$3.26; Brazil—$.90; and Indonesia—$.50. International Economic Report of the President, January, 1977, Figures 43–44, pages 99, 101; Survey of Current Business, U.S. Dept. of Commerce, Bureau of Economic Analysis, March, 1977.

toiletry operations, which extend to the United States only to a very insignificant degree, represent only 35.1 percent of group sales but contribute 49.1 percent to the group's operating profit. Obviously an allocation of group profit to California based on sales will allocate far too large a share of group income to California. This point has been made by Rickett & Colman Limited to the California authorities, but they have rejected it.

California allocates world-wide profits without adjustment for other demonstrable differences. For example, profits in developing countries may be much higher in relation to costs to reflect greatly increased risks of expropriation, currency exchange limitations, or other such factors. The result may be to allocate part of this risk profit, which is really a contingency reserve, to California. California allocates world-wide income even when such income includes substantial profits in foreign countries which are blocked and which for this reason would not be subject to U.S. Federal tax in the case of a U.S. taxpayer until they become unblocked. California even applies its unitary business method to allocate income to California when it is demonstrable beyond reasonable question that actual operations in California have resulted in a loss. Even where a combined return for an entire corporate group shows a net loss for a group, California requires payment of a minimum tax on corporations by each corporation in the group that is incorporated, or qualified to do business, in California.

It is no answer that these or other considerations may in particular cases work in reverse to under-allocate income to California. The real point is that the extension of the unitary business concept to allocate income which includes income arising outside a homogenous economic system, such as the United States, almost certainly introduces major distortions. These distortions would not arise under the alternative application of the arm's length standard as it is rigidly enforced by the Internal Revenue Service. It is also true, however, as suggested above, that California's conventions in applying its unitary business concept do tend to over-allocate income to California.

The California system applied to world-wide income also produces gross distortions because it allocates before-tax income, not after-tax income. Taxes imposed on income by governments throughout the world do not bear any uniform relationship to income and sometimes tend to be higher than in the United States. In any event, the California system allocates to California a portion of world-wide before-tax net income (determined under California law) of a U.K. corporate group which has been subject to varying tax burdens in the many foreign countries where it has been earned. The result is almost certainly to produce a distortion in the amount fairly allocable to California. In other words, the result is that California may impose more tax as a percentage of after-tax income (the amount available to pay California tax) than the percentage which its nominal rate bears to actual after-tax U.S. income of the group. The California system may thereby allocate to California that part of the income of the group that is required to pay taxes at higher rates than in the United States. In a sense, the California tax becomes a tax on a tax, or at least an income tax on income that has already been fully taxed and is required to pay the tax already imposed. Furthermore as already indicated, California does not allow any credit against its tax for taxes paid to another State or to a foreign country, the presumption being that there is no double taxation of the income allocated to California. This is the plainest kind of extraterritorial taxation—an unfairness that Article 9(4) seeks to prevent in the case of U.K.-controlled groups.

There is a second major reason why it is reasonable to limit California's unitary business method in the case of a U.S. subsidiary of a U.K. corporation so that California may take into account only foreign income of the company doing business in California and its subsidiaries, and not income of other affiliated corporations within the U.K. corporate group which are not doing business in California. It is an unreasonable burden, if not an impossible burden, for a U.K. group not controlled by U.S. persons to provide the financial information to California that is required to make such a unitary computation. A U.K.-owned and U.K.-based worldwide group does not keep its books, or determine income, payroll, plant costs, and sales, in dollars, or by California accounting standards. The required conversion of financial figures to dollars at scores of different exchange rates, with sharp fluctuations, devaluations, and other changes, would be an operational nightmare for a foreign-based group

with extensive international operations. It would also be a nightmare to convert the diversified accounting standards used by such a group into the accounting standards applied by the State of California. California itself does not follow U.S. federal income tax accounting and other concepts in some respects. The cost of compliance with the California requirements in the case of a U.K. world-wide group might conceivably be far in excess of the California tax itself. It is also patently clear that an attempt to enforce these requirements, is an extraterritorial extension of California law to foreign areas in which California has no jurisdiction.

For example, one foreign-controlled corporate group with extensive and diverse world-wide operations has roughly 3,000 separate taxable entities. The group estimates that full compliance with the California unitary business method could require administrative costs of $100,000 per year or more, as compared to real net income from California operations of $2,000,000 per year. The California unitary business method, however, allocates as much as $6,000,000 of net income per year to California. The California nominal corporate tax rate is 9 percent. Under these conditions, the combined effect of the unitary business method and the cost of compliance therewith raises the effective California tax rate to 32 percent rather than 9 percent.

Further, financial information may reflect confidential data, trade secrets, or important information that cannot be made available to governmental units having no connection with the companies involved. In the case of foreign affiliates less than 100 percent owned, it may be illegal under the laws of their country of incorporation to provide such information to third parties, such as California. This burden is clearly recognized in the report of the Task Force on Foreign Source Income of the House Ways and Means Committee, supra.

The record keeping necessary to facilitate full compliance with the California unitary business method would obviously place intolerable burdens upon a group of affiliated foreign corporations, particularly where there are diversities of language, currencies, foreign exchange, accounting methods, and accounting periods. Furthermore, there is the problem of compelling compliance with California rules and standards in order to show that all groups in like circumstances are treated on an equitable basis. The Journal of Commerce for June 8, 1977, contains a report of an interview with Tom Quinn, special assistant to Governor Brown of California. In this interview Mr. Quinn stated that the unitary tax law is difficult to enforce and that it could invoke sending State auditors "all over the world". Under such circumstances, can it be denied that the application and enforcement abroad of California law is an extraterritorial extension of State law into the jurisdiction of a foreign government? A chaotic international situation could arise if the unitary business doctrine applied by California were to be adopted by all of the fifty States.

Finally, the California unitary business concept imposes unreasonable burdens because it is applied wherever there is more than 50 percent intercompany control within the group without adjustment for the minority ownership. Assuming a constant 51 percent intercompany control, California law requires an allocation of the entire net income on a combined basis, notwithstanding the highly significant minority interest. The California law makes no provision for an allocation of a ratable share, as do sections as 551, 951, 1246, and 1248 of the Internal Revenue Code of 1954, referred to above.

PRIOR CONGRESSIONAL CONCERN AS TO UNITARY BUSINESS CONCEPT OF SOME STATES

In 1959, Congress adopted Public Law 86-272 (15 U.S.C.A. 381), which placed certain restrictions on the jurisdiction of a State to impose an income tax on a corporation engaged in interstate commerce. Title II of such law, as amended, provided for a study by the Committee on the Judiciary of the House of Representatives and the Committee of Finance of the Senate, acting separately or jointly, or any duly authorized subcommittee thereof, of all matters pertaining to the taxation of interstate commerce by the States, territories, and possessions of the United States, or any political or taxing subdivision of the foregoing, and for a report, together with their proposals for legislation, on or before June 30, 1965.

The study authorized by Public Law 86-272 was conducted by a subcommittee of the House Judiciary Committee; the chairman was Congressman Edwin E. Willis. The report of this subcommittee, entitled "State Taxation of Interstate Commerce," was published in four volumes during 1964 and 1965 as H. Rep. No.

1480, 88th Cong., and H. Rep. No. 565, 89th Cong. Volume 4, beginning with page 1117, contains the legislative recommendations of the Committee on the Judiciary. On the division of income among the States, the Committee recommended a formula apportionment composed of property and payroll factors, without the use of a sales factor. This formula was to be used without the use of specific allocation or separate accounting. The report stated on page 1155 that the "unitary business" rules provide vague and sometimes unevenly administered standards for determining when the income of a multicorporate enterprise should be treated as a whole. With respect to the attempt of States to tax corporations which operate outside the United States, the Committee stated:

"In keeping with the basic structure of our Federal system, the Committee is of the view that international tax policy should be formulated by the Federal Government and not by individual States. Therefore, with respect to income earned by corporations which operate either wholly or partially outside of the United States, the Committee recommends that State apportionment rules be required to conform to the international policies that have been formulated for Federal income tax purposes.

"Thus, if the immunity of any income from taxation by the United States results from its being considered to be from sources outside the United States, such income could not be attributed to any State of the United States. Likewise, no State would be allowed to require that such income be included in the consolidated income of a multicorporate enterprise for apportionment purposes. These prohibitions apply to corporations incorporated outside of the United States and are designed to eliminate inconsistencies which currently exist between Federal policy and the practice of a few States.

"At the same time, if a corporation is considered to have income from sources outside the United States and that income is taxable by the United States, such income could be included in a State's tax base prior to apportionment and the State would not be required to include property or payroll located outside the United States in its apportionment formula. These rules would apply to corporations incorporated in the United States and are designed to make available for apportionment among the States all of the tax base available to the United States."

The Committee's Recommendations, including the recommendation to exclude the foreign source income of a foreign subsidiary, were incorporated in the proposed Interstate Taxation Act (H.R. 11798, 89th Cong. (1965)). This bill met with strong opposition. Section 202(2) of the bill prohibited any adjustment by a State to the Federal taxable income base if "it would include in the entire taxable income of a corporation not incorporated in any State any income which under the Internal Revenue Code of 1954 is not taxable by the United States as a result of being considered to be from sources without the United States or as a result of being otherwise connected or associated with or attributed to activities or occurrences without the United States."

The bill was rewritten and reintroduced as H.R. 16491, 89th Cong. (1966), which in turn was replaced by H.R. 2158, 90th Cong. (1967). H.R. 2158 passed the House by an overwhelming margin but died in the Senate. The bill was again introduced as H.R. 7906, 91st Cong. (1969), which passed the House but died in the Senate. It was again introduced as H.R. 1538, 92d Cong. (1971). Two other comparable but different bills were S. 317. 92nd Cong. (1971), and S. 1883, 92nd Cong. (1971). None of these were enacted. S. 317, as introduced by Senators Ribicoff and Mathias, prohibited a State from determining the tax on a corporation with a local business location by taking into account the income and other tax attributes of related corporations having no business location within the taxing jurisdiction. This provision would have applied even in the case of affiliated corporations all of which are located in the United States.

Earlier on February 4, 1969, Senator Ribicoff made the following statement (115 Cong. Rec. 2597) when he introduced S. 916, 91st Cong., which embodied H.R. 2158, 90th Cong., with amendments:

"A major objection to the unitary concept is that the California practice requires the inclusion in unapportioned tax base of "foreign source income" which is earned in countries outside of the United States and which is not even included in the measure of the Federal income tax imposed by the United States. For example, under the California practice, a Connecticut corporation—with an affiliate in California and other affiliates in such countries as Holland, France, Japan, and so forth—is required to include in the measure of the

California tax the income of the foreign affiliates as well as the income of the California affiliate and the Connecticut affiliate. Besides being highly inequitable, this practice conflicts directly with international tax policies of the Federal Government and, if permitted to continue, can result in a situation in which various States of the United States are formulating their own international tax policies without taking into account the international trade policies of the Federal Government."

This legislative history at the very least demonstrates the need to conform State rules to the Federal rules in areas governed by the international tax policy of the U.S. Government. The only way the latter objective can be achieved is either through Federal legislation or by use of the treaty power of the Federal Government. The two approaches are complementary. Federal legislation could be adopted to prevent the use of the unitary business concept by the States with respect to foreign income of U.S. corporations and their subsidiaries, at least until such income is taxed by the Federal Government itself. A treaty is necessary to protect U.S. businesses from the use of the concept by foreign countries.

Article 9(4) of the proposed tax treaty is necessary, in its reciprocal application, to protect U.S. affiliated companies operating in the United Kingdom through a member corporation from the use of the unitary business method by the United Kingdom. Absent the tax convention, there is nothing (aside from section 891 of the Internal Revenue Code, see infra) to prevent the use of the concept by the United Kingdom in retaliation for its use by California or any other State against corporations resident in the United Kingdom. This issue is purely a matter of international tax policy over which no State has jurisdiction under the Constitution.

Even Federal laws have no force in a foreign territory except in respect of U.S. citizens only. Operations of the nation in a foreign territory must be governed by treaties, international understandings and compacts, and the principles of international law. *United States* v. *Curtiss-Wright Export Corporation*, 299 U.S. 304, 318, 57 S.Ct. 216, 220 (1936).

WIDESPREAD OBJECTION BY OTHER COUNTRIES TO CALIFORNIA UNITARY BUSINESS SYSTEM

The United Kingdom is not the only country to object vigorously to California's unreasonable extension of its taxing power to foreign income realized by a U.K. parent corporation and its U.K. and third country affiliates, when such parent and affiliates are not doing business in California. Many other foreign governments are also presently seeking protection through the treaty process. This in and of itself calls into sharp question the extension by California in recent years of its unitary business method to foreign-owned corporate groups.

In addition, recently it has been widely reported in the press that Japanese automobile companies considering the location of assembly plants in California have advised Governor Edmund G. Brown of that State of their strong objection to the unitary method.[3] Governor Brown reportedly is reconsidering the application of the method to foreign-based broups with operations in California. The Japanese companies reportedly objected in particular to being required "to tell California details of their domestic operations in Japan, and their business in third countries."[4] The Japanese electronics companies, also considering the location of plants in California, have taken the same position.[5]

The California Franchise Tax Board held hearings on July 12, 1977, to consider the effect of the unitary method in discouraging investment in California. The organizations filing this statement also filed a statement in those hearings stating that the unreasonable tax burdens on U.K. corporate groups resulting from the unitary method will strongly discourage British investment in California. At the present time, a major U.K. corporate group, the Beecham Group Limited, is considering causing its U.S. subsidiary to remove all of its establishments in California to another State and to cease doing any business there.

It is reported that a representative of Governor Brown proposed to the California Franchise Tax Board in the hearings that consideration be given to

[3] Journal of Commerce, June 8, 1977; Barron's June 6, 1977.
[4] Journal of Commerce, June 8, 1977.
[5] Barron's, June 6, 1977.

excluding foreign companies not doing business in California from the unitary computation.

The principle of the unitary business concept is so unreasonable that some U.K. companies that actually benefit from its application (because the distortion quixotically end to work in their favor) still strongly oppose it in principle. They are deeply concerned that the principle will be adopted by other countries in the world, particularly developing countries as hereinafter indicated, to maximize their tax revenues.

THE TREATY NEGOTIATIONS WERE WELL-KNOWN

In May, 1977, the National Association of Tax Administrators, in a meeting at Williamsburg, Virginia, unanimously passed Resolution No. 13, paragraph 2 of which provides that the Association opposes the "unprecedented action adopted by the Executive Branch in secretly bargaining away the states' taxing powers" in negotiating the proposed U.S.-U.K. treaty. The preamble of the resolution noted that "the secretly negotiated Treaty for the first time in the nation's history restricts state taxing powers."

These statements are incorrect. It has been demonstrated that treaties of Friendship, Commerce, and Navigation entered into by the United States in the 1920's, and perhaps earlier, placed restrictions on the States' taxing powers. As indicated in the Senate report on the existing treaty with the United Kingdom entered into in 1945, which is still in effect, these earlier treaties formed a basis for including a nondiscrimination clause with respect to State and local taxes in that treaty and in most of the income tax treaties negotiated by the United States after 1945.

As far as secrecy is concerned, all interested parties are being afforded an opportunity to present their views at this current hearing. The Treasury Department announced on eight different occasions by complete news releases that Treasury was negotiating a treaty with the United Kingdom, and the draft treaty was revised several times by protocols. Treasury Department News Releases WS-379, September 11, 1975; WS-454, November 4, 1975; WS-562, January 6, 1976; WS-825, May 3, 1976; WS-1057, August 31, 1976; B-32, February 11, 1977; B-90, March 9, 1977; B-322, July 1, 1977. Obviously the negotiations would have been crippled by direct State participation in such negotiations. Furthermore, the value and correctness of giving the Executive Branch sole control over negotiations has been clearly recognized by the Supreme Court in *United States* v. *Curtiss-Wright Export Corporation*, 299 U.S. 304, 320, 57 S.Ct. 216, (1936):

"* * * It is quite apparent that if, in the maintenance of our international relations, embarrassment—perhaps serious embarrassment—is to be avoided and success for our aims achieved, congressional legislation which is to be made effective through negotiations and inquiry within the international field must often accord to the President a degree of discretion and freedom from statutory restriction which would not be admissible were domestic affairs alone involved. Moreover, he, not Congress, has the better opportunity of knowing the conditions which prevail in foreign countries, and especially is this true in time of war. He has his confidential sources of information. He has his agents in the form of diplomatic, consular and other officials. Secrecy in respect of information gathered by them may be highly necessary, and the premature disclosure of it productive of harmful results. Indeed, so clearly is this true that the first President refused to accede to a request to lay before the House of Representatives the instructions, corrspondence and documents relating to the negotiations of the Jay Treaty—a refusal the wisdom of which was recognized by the House itself and has never since been doubted. In his reply to the request, President Washington said:

"'The nature of foreign negotiations requires caution, and their success must often depend on secrecy; and even when brought to a conclusion a full disclosure of all measures, demands, or eventual concessions which may have been proposed or contemplated would be extremely impolitic; for this might have a pernicious influence on future negotiations, or produce immediate inconveniences, perhaps danger and mischief, in relation to other powers. The necessity of such caution and secrecy was one cogent reason for vesting the power of making treaties in the President, with the advice and consent of the Senate, the principle on which that body was formed confining it to a small number of members. * * *'"

IMPORTANCE OF THE PRINCIPLE OF ARTICLE 9(4) TO THE UNITED STATES

This treaty is an appropriate place for the United States in its own interests to establish a limitation on use of the unitary business concept as to income arising outside of a foreign country (or its political subdivision) that imposes its tax on such a basis. If California continues its treatment of foreign-owned corporated groups, U.S. companies may suffer retaliation by other countries (and their political subdivisions) in which they do business. The United States itself, of course, will bear a large part of the burden of such foreign country actions, because increased foreign taxes may result in decreased U.S. taxes by reason of the foreign tax credit. In such a situation it would be difficult to invoke the use of section 891 of the Code, since the foreign action would simply be in retaliation for the method followed by California.

Of even greater concern, other foreign countries, particularly developing countries, may adapt the unitary business concept in particular ways to impose greater tax burdens on U.S. companies. In one case, a developing country recently attempted to tax airline and shipping companies (but not other companies) by allocating worldwide income of such companies, and all companies related to them, based on the relationship of passenger and freight revenues involving that country to total passenger and freight revenues. This would have been an allocation based on a major part (but not all) of one factor, sales; if plant and payroll had also been given weight, the allocation would have been much less. Furthermore, in practical effect, the result was to increase the tax burden of only one taxpayer, a U.S. shipping company which actually had a loss from operations. Because, however, such U.S. company was a subsidiary of a much larger group of U.S. controlled companies engaged in many different businesses throughout the world, the result was to allocate a large amount of taxable income to that foreign country. Thus, the unitary business concept in practical effect would have reached only one company, a U.S. company, and would have created income to tax even though the shipping operations of the U.S. group had resulted in a loss.

Fortunately, the result was so extreme that the courts of the foreign country in question struck down the effort. The attempt by the foreign government almost succeeded, however, and there is no assurance the courts of other countries will react in the same favorable way to U.S. companies. The United States can protect itself from such extremes by treaties containing an article such as Article 9(4), which by its terms is reciprocal and binding on the United Kingdom.

If the concept spreads to other countries, U.S. companies may be forced to provide confidential financial information and other data, just as California seeks from U.K. companies. Consider the impact of an unfriendly nation insisting upon details as to U.S. plant costs, U.S. research and experimental expenses, and other such information from a U.S. company with extensive defense production of secret products, or one engaged in nuclear reactor construction. The provision of such information may be contrary to an entire series of U.S. laws, just as the provision of information to California may violate the laws of various countries in the world in which a U.K.-controlled corporate group may be doing business.

A RESERVATION ON ARTICLE 9(4) COULD JEOPARDIZE THE TREATY

As previously demonstrated, the volume of U.S. direct investment in the United Kingdom is two to three times the volume of U.K. direct investment in the United States. In addition, it is self-evident that a payment by the United Kingdom of one-half the ACT, imposed at a 35-percent rate, to U.S. direct investors, and a payment of the full ACT to U.S. portfolio investors, is a very important concession by the United Kingdom, as compared to the reduction by the United States of its withholding rate on intercompany dividends from 15 percent under the existing treaty to a 5 percent as a result of the pending treaty.

These comparisons were considered at length in the U.K. House of Commons when this treaty was debated on January 12, 1977. It was emphasized that it required nearly four years for the U.K. Department of Inland Revenue to decide to make the concession of the ACT refund to U.S direct investors. The sensitivity of this treaty was underscored by the fact that it was not considered in

committee in the House of Commons; it was debated at length on the floor of the House of Commons and was defended by the U.K. Treasury Ministers.

Article 9(4) was discussed prominently in these debates. Its importance to United Kingdom companies, and the unreasonable effects of the California unitary business method in its operations, were emphasized. It was recognized that the concept of the unitary business method is contrary to well-established international principles and is wholly unacceptable to the U.K. Government and other countries in the world.

It is obvious from the Parliamentary debates that there were differences of opinion and that there was no automatic approval of the treaty.

If the United States Senate were not to ratify the treaty as recommended by President Carter, the situation in the United Kingdom would at the very least be highly uncertain. It would be necessary in all events to go back to the U.K. Parliament. In the United Kingdom, treaties are either approved as recommended by the executive branch or are disapproved in toto; they are not approved conditionally or with any reservations. There is no precedent in the United Kingdom for taking a treaty back to Parliament, as a result of a reservation by the other government, after it has been once approved by Parliament. If the United States Senate were to approve the treaty with a reservation on Article 9(4), the constitutional posture of the matter in the United Kingdom will require further consideration by the U.K. Government.

Because of the controversial nature of this treaty, it is entirely possible that a reservation on Article 9(4) would necessitate a renegotiation of the entire treaty, because of the great significance of the article to the U.K. Government.

There is also a problem with respect to the effective date of the treaty. In its present form, the U.K. Government has agreed to pay U.S. portfolio investors the full ACT credit back to April 6, 1973. In the case of U.S. direct investors, the payment of one-half of the ACT credit is retroactive to April 6, 1975. This is a highly unusual concession by the U.K. Government in a tax treaty; it is justified because the treaty was the subject of negotiations over an extended period of years beginning shortly after the new U.K. imputation system of taxing corporate income took effect. If it were necessary for the treaty to be reconsidered by the U.K. Parliament, however, it is entirely possible that these retroactive effects, which are so substantially beneficial to U.S. direct and portfolio investors, may be eliminated. Again, the U.S. Treasury would suffer because the U.S. taxpayers would thereby obtain foreign tax credits for the U.K. income taxes which would have been paid by them without benefit of the ACT credit.

The importance of inclusion of Article 9(4) in the treaty without reservation is, therefore, self-evident.

CONCLUSION

In the last analysis, as recognized in the Ways and Means Task Force report of March 8, 1977, there is little need for California to include income of a U.K. parent or its affiliates in the unitary business computation where such parent or affiliates are not doing business in California:

"The need for applying the unitary method may not be as a great when taking into account foreign source income than when taking into account income from a number of States. The number of transactions in any State linked to foreign operations is ordinarily substantially fewer than the number of transactions linked to different States. Moreover, since taxpayers are in any event required to allocate income between U.S. and foreign sources for Federal income tax purposes, the State could adopt the Federal rules for apportioning income from foreign transactions between domestic and foreign sources."[8]

This conclusion is particularly applicable in the case of the present treaty, which would limit California only with respect to income of a U.K. parent controlled by U.K. persons, not doing business in California, and its U.K. and third country affiliates not doing business in California. Foreign and domestic income of a U.S. subsidiary of the U.K. group doing business in California, and its subsidiaries, could still be included (supra, pp. 12–15).

The principle in Article 9(4) is entirely consistent with international norms of taxation and with the treaty power of the Federal Government to restrict

[8] Recommendations of the Task Force on Foreign Source Income, *supra* at p. 29.

taxation, including taxation by its political subdivisions, in the interests of fostering international trade and investment between the United States and the United Kingdom. The United Kingdom is the country with which the United States has had the greatest volume of trade and exchange of investment over the course of history, and that relationship should be strengthened by ratification of this treaty in its entirety.

The proposed treaty contains a critical, major concession by the United Kingdom whereby one-half of the ACT credit will be paid to U.S. direct investors under the U.K. imputation system of corporate and shareholder taxation. The full ACT will be paid to U.S. portfolio investors. These concessions are of major importance to U.S. direct investors, particularly because of the expanding multibillion involvement of U.S. companies in North Sea oil development. It is also of major importance to the United States because of its precedental value in concluding upcoming treaties with Canada and with the Common Market countries—particularly West Germany, France, and Denmark. The U.K. treaty obviously is the testing ground for establishing the principle that U.S. direct and portfolio investors should receive nondiscriminatory treatment by receiving payment of the shareholder credit in the same manner as residents of the foreign country.

One of the most significant protections provided to the United Kingdom in this treaty is Article 9(4). This issue represents an important matter of principle to U.K. industry. California cannot be permitted to tax U.K. groups in a manner contrary to well-accepted international tax standards. If Article 9(4) is not accepted by the United States, the treaty as a whole is in serious jeopardy.

The Senate Foreign Relations Committee should recommend ratification of this treaty to the Senate without reservation.

JOHN S. NOLAN.

Senator CHURCH. Thank you, Mr. Nolan.

Our next panelist is Ernest I. Reveal of the R. T. French Co.

STATEMENT OF ERNEST I. REVEAL, PRESIDENT, R. T. FRENCH CO., ROCHESTER, N.Y.

Mr. REVEAL. Thank you, Mr. Chairman.

I am grateful for the opportunity to appear before you as a representative of both a United States and a United Kingdom corporation to speak in favor of the proposed Income Tax Treaty, between the United States and the United Kingdom, and particularly article 9, subsection 4 limiting the application of the unitary income concept.

My name is Ernest Reveal and I am president of the R. T. French Co. In addition, I am a Director of French's parent company, Reckitt & Colman, Ltd.

Reckitt & Colman, Ltd., is a public British company, domiciled in the United Kingdom, whose stock is listed on the London Stock Exchange. The company operates mainly through subsidiaries in some 40 countries and trades with most other countries in the free world.

Its subsidiaries manufacture products primarily in the food, household, toiletries, pharmaceutical, and leisure fields. Sales in 1976 approximated $850 million and after-tax earnings were nearly $50 million.

Reckitt & Colman's main intrest in the United States is represented by the R. T. French Company, a food processor principally of condiments and potatoes, with plants in California, Pennsylvania, Idaho, Nevada, Missouri, Maryland, and New York State. It is a prime example of the type of entity which will benefit from the narrow exception provided in article 9(4) of the treaty.

EFFECT OF ARTICLE 9(4) ON STATES

Now, I am not an expert on taxation. I am only a businessman. But those who advise me have pointed out that the language of article 9(4) is in reality a very narrow exception to the unitary income concept. This, I believe, is a most important point for your deliberation.

Contrary to what you may have been told, article 9(4) does not adversely affect unduly any State utilizing the unitary income concept. It only excludes from the tax base of such State the income of the United Kingdom corporation and its affiliates in a third country which has absolutely no connection with that State.

Senator JAVITS. Let me interrupt you. When you say a third country, do you mean neither in that State which is doing taxing or in the United Kingdom?

Mr. REVEAL. Yes, sir.

Senator JAVITS. But its operations are in another country altogether?

Mr. REVEAL. Yes, sir.

Thus, any State applying the unitary income concept will be able to continue, as in the past, to include the income of the R. T. French Co. and its subsidiaries in its tax base. Article 9(4) simply prevents any State from including the worldwide income of Reckitt & Colman, Ltd. This result is certainly in keeping with the doctrine of fairness and arm's-length dealing inherent in the U.S. Federal Government's treatment of allocation of related member income under the Internal Revenue Code, and should not infringe on States' rights.

CONTINUING INEQUITIES IF ARTICLE 9(4) WERE DELETED

In addition to this concept of fairness, there are several inequities which will continue to prevail if article 9(4) were deleted from the treaty.

1. The States unitary income concept as applied to a United Kingdom corporation places an unreasonable burden on such a corporation.

First, before an adequate income base may be derived, all profits of the parent company, Reckitt & Colman, its subsidiaries and their subsidiaries, must first be converted to equivalent United States earnings and profits. This is no easy task since there are substantially different concepts throughout the world concerning allowances on fixed assets, valuations of inventories and taxation of capital gains, to cite just a few examples. Such profits properly adjusted must then be converted to U.S. dollars using U.S. principles of conversion, a complicated and expensive job.

Second, profits do not accrue worldwide in proportion to sales but are almost certain to accrue at different percentages on different classes of business. To illustrate, the business of the R. T. French Co. is predominantly food in which there is an overall lower rate of profit than in the pharmaceutical and household businesses of Reckitt & Colman in other parts of the world. The unitary income basis of assessment would result in part of the profits of these non-U.S. businesses being assessed by any State applying the concept. The inequity here should be obvious.

2. A further inequity relates to the factors of production, As Mr. Nolan pointed out, wages, for example, are higher in the United States. Thus when wages earned by a person in New Guinea are combined with wages in, say, California or Alaska, the unitary State will usually allocate more income to itself merely because the unitary State has a higher wage level. Similarly, if a unit of construction costs more in the unitary State than the world average, more profit would be allocated to that State.

It is estimated that 40 percent of the world's resources are consumed by 6 percent of the people who happen to live in the United States. How then can the resources in a unitary State be fairly compared to the resources of the world to arrive at a just allocation of income? Under this approach, the higher the cost, the higher the profits. Economics just does not work that way.

I have been talking about the inequities arising from the application of the unitary income concept. These inequities, however, must be compounded when you consider the application of not one but fifty unitary income concepts, as each of the 50 States attempts to adopt and apply a version of the concept. This certainly is not idle speculation but a very real possibility. The cost not only of compliance, but of increased taxes, become prohibitive.

R. T. French has determined that if the State of California were to assess the company for the year 1972–73 under its unitary income concept, as it has indicated it would like to do, the tax would be 150 percent higher than what was paid for those years.

Consider the implications for French in each of the 50 States and you can begin to appreciate the impact it will have on our ability to effectively compete in any marketplace in the United States.

To the extent that these increased taxes can be used as deductions on our Federal return, the Federal Government will receive that much less in tax dollars.

INTERNATIONAL BUSINESS CONSIDERATIONS CONCERNING ARTICLE 9(4)

In addition to the equitable considerations which arise from retention of article 9(4), there are some important international business considerations which should not be overlooked.

As evidenced in other areas of international relations, whenever inequities or barriers are constructed by nations, other nations are quick to respond with their own form of retaliation. To the extent that the various States of these United States are left unchecked in their pursuit of expanding tax bases, foreign nations must as a result of pressure from their own business enterprises erect obstructions of their own. I shudder to think of the needless time and expenses our company alone would incur in the preparation of unitary profit and loss statements for forty different countries, each with their own unitary earnings and profit concepts. And to the extent that these countries have States within their borders, well it literally boggles the mind.

I firmly believe that foreign industries will balk at going to unitary tax States to do business. Recent news articles would seem to indicate that the unitary income tax concept as applied by certain States is clearly discouraging would-be entrants from establishing businesses

in those States. Unfortunately only time can prove the extent to which that may be true.

However, for Reckitt & Colman, Ltd., and French, the ratification of this treaty in its present form, including article 9(4) will alleviate our concerns and permit us to move ahead with confidence in investing for growth in this country.

Gentlemen, I thank you for your time and to the extent that I am able to do so, would be happy to answer any questions you may have.

[Mr. Reveal's prepared statement follows:]

PREPARED STATEMENT OF ERNEST I. REVEAL, PRESIDENT, R. T. FRENCH COMPANY

The R. T. French Company on behalf of itself and its parent company, Reckitt & Colman Limited, is in favor of ratification of the proposed U.S./U.K. Tax Treaty in its present form. Both French and Reckitt & Colman have a special interest in the retention of Article 9(4) of the proposed Treaty which deals with "unitary income."

Reckitt & Colman Limited is a publicly held company in the United Kingdom whose some 60 million shares are traded on the United Kingdom Stock Exchange. The company operates mainly through some 120 subsidiaries in approximately 40 countries and trades with most other countries in the free world. Its products are in food, households, toiletries, pharmaceutical and leisure fields. Its sales in 1976 approximated $850 million and its after tax earnings approximated $50 million. Its main interests in the United States are via The R. T. French Company which is in the food industry principally in mustard and other condiments and potatoes. French's headquarters are in New York State. French has manufacturing facilities in California, Idaho, Nevada, Missouri, Pennsylvania, New York, and Maine. Doing business in these and other states, French has no basic quarrel with a unitary concept applied within the boundaries of a country but believes that the system applied on an extra-territorial basis is inequitable and invites retaliation. Before elaborating on these two points it might be well to review the unitary concept of taxation and at the same time describe the limitation afforded by the Treaty under consideration.

THE UNITARY CONCEPT

The unitary concept deals with the ownership reality that the parent company owns all of its subsidiaries. It treats this group of companies as one (unitary) and taxes this group on the computed portion of profits of the entire group attributable to the taxing state. Two types of unitary taxaion have been used by several of our (United) States: taxation of an entire U.S. multinational group; and taxation of an entire foreign multinational group by targeting a subsidiary of such a group as the host taxpayer. The treaty under consideration is limited to the latter type of unitary taxation and only with respect to United Kingdom companies. Nonetheless French believes that ratification would remove inequities that French and other U.S. subsidiaries of U.K. multinationals now must deal with.

INEQUITIES IN THE UNITARY SYSTEM

The major inequities in the unitary system from French's and Reckitt & Colman's viewpoint stems from (1) differing profit margins throughout the world, (2) data conversion costs, (3) apportionment factor overweighting and finally, (4) an overall administrative burden associated with preserving the separate entity concept. Each of these four inequities will be reviewed separately.

DIFFERENT PROFIT MARGINS

Apart from the fact that profits do not accrue worldwide in proportion to sales, profits will almost certainly accrue at different percentages on different classes of business. The business of The R. T. French Company is predominantly in food in which there is an overall lower rate of profit than in the pharmaceutical and household businesses of Reckitt & Colman in other parts of the world. The unitary basis of assessment would result in part of the profits of these non-U.S. group businesses being accessible in the states. The inequity here should be obvious: the assessing state should be limited to taxing only profits earned directly or indirectly in that state. A state attempting to reach into

profits not remotely connected with any business operating within that state should be prohibited.

COST OF PROVIDING DATA

Another inequity is the cost of providing income data to supply the administrators of the unitary system. Before an adequate income base may be derived, all profits of some 120 subsidiaries and the parent company, Reckitt & Colman, should first be converted to equivalent United States earnings and profits. This would be no easy task since there are substantially different concepts throughout the world concerning allowances on fixed assets, valuations of inventories, and taxation of capital gains. These are some examples of concepts which could differ materially from United States taxation concepts. Such profits properly adjusted must then be converted to U.S. dollars using U.S. principles of conversion. The alternative to this costly method which is most often used as an expedient is to accept the method employed by one unitary state: profit per U.K. annual report × dollars per pound = unitary taxable income. This number even incorporates unrealized currency gains and losses in pounds converted to dollars! Such a number is not only a fiction in the home currency but is pure fantasy in terms of any U.S. taxing authority. The reason that such a number may be reluctantly accepted is that the cost of conversion could easily exceed the marginal tax assessment gained by the unitary state using the alternative method rather than the correct method.

A contrast to the unitary approach of arriving at taxable income is the one employed by most states: begin with U.S. federal taxable income and make adjustments. Many states' income tax returns look complicated but nonetheless all data required to file such returns can be generated internally without going to the parent with a research project just to comply with the demands of a unitary state.

APPORTIONMENT FACTOR OVERWEIGHTING

To continue the inequity, it must be obvious that the factors of production—wages for example—are proportionately higher in the United States—which includes our unitary states of California, Alaska and Oregon—than in the rest of the world on the average.

The apportionment of income is derived by multiplying the income derived above by the "apportionment factor." The factor technique is used in all states that levy an income tax but the non-unitary states stick with U.S. only factors rather than worldwide. The factors for apportionment are sales, payroll and tangible assets which closely parallel the Adam Smith factors of production: land, labor, entrepreneur, and capital. The "apportionment factor" is the unweighted average of the above factors in the unitary state divided by the factors worldwide. Thus wages earned by a person in New Guinea are combined with wages in, say, California or Alaska. When the weighting is complete, the unitary state would usually have allocated more money to itself merely because the unitary state has a higher wage level. Similarly, if a unit of construction costs more in the unitary state than world average, more profits will be allocated to that unitary state. It is estimated that 40 percent of the world's resources are consumed by 6 percent of the people who happen to live in the United States (see W. Stanley Mooneyham, What Do You Say To A Hungry World? Waco, 1975, Word Books). How then can the resources in a unitary state be fairly compared to the resources of the world to arrive at a just allocation of income? Under this approach, the higher the costs, the higher the profits. Economics just doesn't work this way.

OVERALL ADMINISTRATIVE BURDEN

The previous inequities were based on the assumption that a unitary condition existed. The conditions used by some unitary states to utilize an ownership group include common management, common products, common markets, etc. But what if the subsidiary has demonstrated that none of these conditions existed and therefore the subsidiary asserts that the unitary condition does not exist? French has taken this position but was nonetheless requested to answer the questions on the attached exhibit. This burden speaks for itself and needs no further explanation.

It should be brought out that the whole controversy of unitary/non-unitary could be eliminated if the unitary states only had confidence in the United States Government's inter-company pricing policies between related interna-

tional taxpayers. This system has evolved over the years and respects the sovereignty of countries and their right to levy taxes, yet insists on arm's length pricing betwen countries. U.S. negotiators are prepared to resolve international tax disputes as a result of non-arm's length pricing between countries and the legal entities under their respective jurisdictions. This process is known as "competent authority" and represents the ultimate administrative remedy for double taxation. This system recognizes profit centers congruent with legal entities and preserves the integrity of the profits or the losses. The treaty now being considered by this Committee covers this subject in Articles 24, 25 and 26. The unitary system cuts through the separate entity and sovereignty concepts by rejecting both as being meaningless. The unitary states are in effect staking out their own form of sovereignty at the expense of the rest of the world. The unitary theory can no longer be justified on the basis that it eliminates abuses in intercompany pricing. The administrative burden involved in proving a subsidiary to be non-unitary is immense.

RETALIATION TO THE UNITARY TAX

Some observers claim that sovereign entities will retaliate in kind with a similarly burdensome set of tax rules. This may be so but a greater danger—it seems to us—is that foreign industries will balk at coming to unitary states to do business. The coming of new plants does create jobs in unitary states but the unitary taxes are clearly discouraging would-be entrants from establishing business in these states. (See The Wall Street Journal July 12, page 1 and the cover story in the July 11 issue of U.S. News and World Report.) Furthermore, if other states elected to adopt the unitary approach, the total tax burden against French for U.S. state etxes would have been 250 percent higher in 1972–1973 using the California projections. Under these conditions and assuming other foreign companies would get similar treatment, potential foreign taxpayers would certainly be discouraged from establishing a new business and some of those present may seek to get out.

We agree that retaliation by other sovereign countries is also a possibility. The thought of preparing unitary profit and loss statements for 40 different countries each based on their own earnings and profits concepts is unthinkable. This notion could be extended to "states" within those 40 countries.

Unthinkable though it might be, retaliation is not out of the question. Extension of the worldwide sovereignty concept of a unitary state could at some future time force The R. T. French Company, for example, to gather data so that the New South Wales taxing authorities could compute unitary income under its concepts or so that Schleswig-Holstein could compute an apportionment factor. The supplying of information of this nature is clearly counterproductive.

CONCLUSION

The R. T. French Company does not object to paying taxes on its fair share of the profits. It further feels that no country or its political subdivisions should tax more than its fair share of worldwide profits.

It is our belief that the unitary system does just that and that therefore Article 9(4) of the Treaty should be retained in the Treaty as ratified. The ratification of this Treaty, when combined with the extensive and existing intercompany pricing rules, will assure that states can levy a tax on their fair share of profits where a United Kingdom company is a parent to the U.S. subsidiary company-taxpayer and the parent is not doing business in the United States.

STATE OF CALIFORNIA,
FRANCHISE TAX BOARD
New York, N.Y., April 13, 1977.

R. T. FRENCH COMPANY,
1 Mustard Street
Rochester, N.Y.
Attention: Dave Engberg.
Re R. T. French Company, Income Years 1972 and 1973.

We have been instructed by our review section in California to acquire further information in order to complete the audit. The following is the information which is needed.

1. A chart showing the functional organization and the lines of control within the corporate group on a worldwide basis.

2. With respect to those corps. to which French sells goods or from which it receives royalties. Why are these royalties paid? What percentage of the total food sales of these corps. results from the sale of products using materials or processes for which royalties are paid to French and what percentage of their total food sales result from sales of products purchased from French. What percentage of total sales of these corps. does food sales comprise? For control purposes please describe the lines of reporting of these corporations and the rest of the corporate group. Besides food sales what other activities do these corps. engage in? How are these activities integrated into the food sales? This last question should be viewed in terms of common distributors, marketing techniques, accounting, management, collections, credit and all other line and staff functions.

3. How are the worldwide operations of each product group coordinated? What are the policies concerning purity or quality of food products on a worldwide basis? How are these maintained or enforced? Please be very specific on how worldwide policies for each product group are developed, coordinated and enforced on a worldwide basis.

We would appreciate hearing from you as soon as possible. Thank you for your cooperation.

T. J. McAULIFFE,
Auditor.

Senator JAVITS [Presiding]. Thank you.

Our next witness is Mr. Valentine Brookes.

STATEMENT OF VALENTINE BROOKES, BROOKES, BROOKES & VOGL, SAN FRANCISCO, CALIF., ON BEHALF OF EMI-CAPITOL RECORDS, INC.

Mr. BROOKES. I am a California lawyer. I specialize in tax work. I am here to speak exclusively to the proposed article 9(4) in the proposed treaty.

I represent in California for tax matters Capitol Records, Inc. Its name describes or suggests what it does. It makes phonograph records and tape records primarily of music. It is owned entirely by a United Kingdom parent, EMI, Ltd. EMI has no permanent establishment in the United States, though it does own Capitol Records, a subsidiary which operates in the United States.

PRESENT CONTROVERSY WITH CALIFORNIA

For treaty purposes then EMI has no permanent establishment in the United States and is not present here. If the treaty is ratified in its proposed form for the future Capitol will be relieved of burdensome taxes on EMI's income. It has, however, a present controversy with California which I believe will not be affected by the ratification of the treaty and it gives light to some of the discussion that has been heard, particularly from the State representatives who have spoken in such glowing terms of the fairness and equity of the unitary system.

I think the committee might be interested in knowing more about how it actually does work in practice. This controversy with Capitol began with a demand from the Franchise Tax Board to EMI in London for a great many bits of information, quite searching questions coupled with the threat of a 25-percent penalty if EMI failed to respond. EMI did not respond.

A second letter from the Franchise Tax Board produced EMI's refusal to respond on the ground that the United States-United

Kingdom Treaty now in effect was with the United States and that included all 50 States and besides under regular concepts of international law California had no jurisdiction over EMI.

Thereafter, the Franchise Tax Board sent the same letter but with the designee changed to Capitol Records asking for the same information that it had asked of EMI and again with the threat of a 25-percent penalty if the answer was not given in full.

Capitol asked EMI for some help. EMI replied that much of the information that was sought was beyond its own knowledge, it could not assemble it. In the second place, it said "We are governed by British law and we cannot disclose this to you under British law."

The next step was a proposed arbitrary assessment against Capitol. Capitol has protested it and this is where the matter stands at the present time except for some further correspondence between my client and EMI, again pleading for help.

EMI this time has cited the Official Secrets Act which it says it would violate if it gave Capitol this information so that Capitol could give it to a political subdivision of a foreign power. It says that it will not be blackmailed by a threat of arbitrary assessment into the violation of the U.K. Official Secrets Act.

EMI OPERATIONS

Now, a bit more about EMI. EMI not only makes phonograph records and tape records and sells them to subsidiaries; it makes them in the United Kingdom. Through subsidiaries it makes them in Holland and France, Italy and the United States. In addition, it operated the only London privately owned television station in competition with BBC. It operates theaters and studios in which movies are made. It operates hotels, mostly on rented premises. It even operates bingo parlors in the United Kingdom. It manufactures theft prevention devices and sells them throughout the world. It manufactures technical products in the electric industries and electronics industries. EMI takes credit for having developed the airborne radar which was on the aircraft that the British pilots flew in the Battle of Britain. This has kept it deep in British defense work ever since.

It makes and sells throughout the world the brain scanner which is so well known in the United States today and for which it last year won the Queen's Award.

Its defense work in general terms goes into a continued application of radar for aircraft and ships, fighting vessels, proximity fuses, sensing devices, mortar detectors and search vehicles both airborne and waterborne.

Then it engages in research work of considerable secrecy for the United Kingdom, both that which becomes part of products it manufactures and of those manufactured by the Defense Department for Britain, itself, and others.

CAPITOL'S NEED FOR DETAILS

Capitol would need to know the details of all of these enterprises including these military application enterprises in order that Capitol

may be able to tell the California franchise tax board enough to satisfy its curiosity.

Now, all of this is supposed to be necessary in order that California can find out how much of EMI's income it should allocate to Capitol and tax. It should be obvious that some of EMI's income, all of it from operations not involving phonograph records, are none of California's business since none of that operation by EMI is even in the United States. Neither EMI nor Capitol can possibly tell the State of California the details about the research which it does for the British Defense Department or other things that would represent a violation of the Official Secrets Act.

WHAT IS TO BE DONE?

Now, if the United Kingdom itself is not satisfied with this state of affairs involving whipsawing of one of its industries between the British law and the California law, what is it to do?

There has been some suggestion that the United Kingdom should not invoke the treaty procedure. But, it has no representatives in the California Legislature or in Congress and of late there has been considerable expression of concern by the Congress over the propriety of foreign governments lobbying their own positions before the Congress.

So if it has withheld this sort of activity from the Congress it should not be criticized. I think the Senators will agree. It can do as normally foreign governments do in dealing with the United States, enter into a treaty.

Now, there has been a suggestion that there should not be a treaty with the United States but instead with California and another treaty with Oregon and one with Alaska and then with every State which successively may invoke this system of putting foreign income into the unitary group. I do not believe that the Senate of the United States is the place to make the suggestion that foreign powers should engage in making treaties with States.

So far that has been thought to be unconstitutional and hasn't been attempted by foreign countries.

The final alternative suggested indirectly by a preceding witness is that the U.K. enterprises can withdraw operations from the United States. This is a Draconian result which I am sure that the Senate will not suggest is proper. There has been reference also to the impropriety of making what one of the witnesses this morning from my State called an end run around the Congress. The entire treaty-making process, as one of the Senators remarked, could be regarded as doing that very thing.

Let me dwell upon the rest of what this treaty involves as well as every preceding tax treaty. The rest of the treaty and all prior treaties involve only limitation from Federal taxes or something related to Federal taxes.

In the imposition of Federal taxes the House of Representatives has the constitutional power of initiation. If its sensitivities are great on this subject it should, I suppose, be more sensitive about having the power of initiation on Federal taxes taken away from it than having some limited jurisdiction over State taxes taken away from it.

So, it is difficult for me to conceive of how there can be any appropriate suggestion that in this particular area where the House of Representatives normally does not legislate anyway, the treaty process should not be invoked to limit the States.

RESPONSE TO PRECEDING WITNESSES

Senators, I have much to say in response to other things that have been stated by the preceding witnesses of the last day and a half.

I understand that the record will be kept open for enlargement of remarks. If this may be so, I should like to utilize that method of answering some of the other things that I have deferred.

Senator CHURCH. Certainly. The record will be kept open for that purpose.

[Mr. Brooke's prepared statement and enlargement of remarks follow:]

POSITION PAPER OF VALENTINE BROOKES, ESQ. ON PROPOSED U.S.-U.K. INCOME TAX CONVENTION, PARTICULAR REFERENCE TO LIMITATION OF THE POWER OF THE STATES TO TAX

This Position Paper is in support of the position that the section of the proposed U.S.-U.K. Income Tax Convention limiting the power of the States to include U.K. enterprises in allocation formulae of corporations doing business in the United States should be ratified, with the protocol which has since been negotiated as an amendment to the treaty. If any changes be made prior to ratification, the change which this position paper recommends is the elimination of the protocol.

The treaty as originally signed limited the power of the States to include any U.K. enterprise in a unitary group for allocation purposes without regard to whether it was owned by residents of the U.K. or by American interests. Apparently in an effort to mollify the States opposing that provision in the treaty, a protocol was later agreed to limiting the restrictions on State power to tax to those U.K. enterprises which are owned by U.K. residents. The protocol has not had the effect of inducing the States to refrain from opposing the treaty, and since the protocol discriminates against American-owned business doing business in the U.K. and in favor of U.K.-owned business, there seems to be no purpose of American foreign policy in continuing to accept the limitation on the restriction the protocol represents. Nevertheless, if the world has turned on its axis so far that the protocol has become imbedded in the treaty irrevocably, this position paper urges ratification of the treaty with the protocol, rather than its rejection.

The principal opponent of the treaty is the State which has been most ardent in its application of the unitary theory of allocation of net income on a world-wide basis, which is the State of California. Much of the discussion herein will therefore be of the position of the taxing agency of that State, and of the Courts of that State.

First, it appears quite possible that the California Supreme Court would hold that under some circumstances the existing U.S.-U.K. income tax convention would prohibit the inclusion of U.K. enterprises in the unitary group California would create for its taxing power. In *Scandinavian Airline System, Inc. v. County of Los Angeles*, (1961) 56 Cal. 2d 11, 14 Cal. Rptr. 25, 363 P. 2d 25, cert. den. 368 U.S. 899, the California Supreme Court held that the County of Los Angeles could not tax the airplanes of SAS because of the income tax conventions in effect between Sweden and the United States. From the opinion it appears that each of the three foreign countries owned one or more of the airplanes operating between Copenhagen and Los Angeles. Los Angeles County attempted to tax an apportioned amount of the value of each of the airplanes. The Swedish treaty contained a provision which the California Supreme Court interpreted as applying to local property taxes of Sweden, and which it considered would have prevented the Swedish local governments from taxing the property of an American enterprise in reverse circumstances. It therefore con-

cluded that the Swedish airplane was exempt from State taxation on reciprocal principles it found in the treaty. It concluded also that in spite of the lack of parallel provisions in the Norwegian and Danish income tax treaties with the United States, those countries were entitled to the benefits of a most favored nation clause it found in each of their treaties, and hence they enjoyed the same exemptions for their airplanes which the Swedish airplane was found to enjoy. The Court went further and held, as an alternative ground (14 Cal. Rptr. at 43) that federal constitutional provisions prevented California from discriminating between foreign nations, and therefore it must accord each nation the favored treatment the Swedish treaty provided for the Swedish property. The California Supreme Court summarized its conclusions by stating:

"This is but another way of saying, as we have said above, that taxation of foreign owned and based instruments of commerce represent a field that is peculiarly federal in nature, without regard to such specific constitutional considerations as the commerce clause or the due process clause, and which must be left to the administration of the federal government, even in the absence of any present federal legislation thereon."

One would suppose that the California Supreme Court would voice the same views in an income tax case, since the tax treaties it construed were income tax treaties, except for one minor provision in the Swedish treaty. It appears quite possible, accordingly, that California's own Supreme Court would hold that under at least some circumstances the existing treaty limits California more broadly than the proposed treaty with the protocol added.

The California Supreme Court's decision in the *SAS* case was by a divided Court. Both of the dissenting justices have since left the Court. A treaty case is pending before the Court now and the Court will have the opportunity to decide whether to continue to apply the *SAS* case, or to extend it further, or to limit it. Until the case now before it has been decided, one must assume that the *SAS* decision continues to represent the views of that Court. In assessing the significance of the opposition of the California taxing agencies to the proposed treaty, therefore, one must reckon with the distinct possibility that the highest court of California would hold that under existing treaties California cannot constitutionally do what its tax agency contends it is doing consistently.

Moreover, the only California appellate decision which has involved the California tax authorities' attempts to go worldwide in their consolidation and unitary formula theories is directly opposed to the tax agency's position. It rejected their position completely. That decision is *Chase Brass and Copper Corporation v. Franchise Tax Board*, 7 Cal. App. 3d 99, 86 Cal. Rptr. 350; 10 Cal. App. 3d 496, 87 Cal. Rptr. 239; 95 Cal Rptr. 805. On the issues the Franchise Tax Board lost, no hearing was sought in the California Supreme Court, so the decision has become final on those issues, although it continues actively in the Courts on the issues on which Chase lost. The case involved the effort by the Franchise Tax Board to consolidate Kennecott Copper Corporation and all of its subsidiaries with Chase Brass and Copper Corporation, which was entirely owned by it. Among those other subsidiaries was Braden Copper Corporation, a Maine corporation which operated exclusively in Chile. In that country it owned and operated a copper mine, smelter, and refinery. In the taxable years, a consideratble portion of the refined copper of Braden was sold by Kennecott in the United States, but ordinarily Braden copper was sold in European and Asiatic markets, not in the United States. Both Kennecott and Braden conducted, generally, the same type of copper business. The Court sustained the consolidation of Chase with Kennecott's copper business and the application of the allocation formula to the combined copper net income of the two corporations, but it held that Braden was not part of that unitary business, because Braden conducted its copper business in a foreign country and not in the United States. The California tax authorities consistently cite the *Chase Brass* decision as authority for the consolidation of various commonly owned corporations conducting a domestic business, but with equal consistency reject the possibility that any portion of the decision which is adverse to any of their other contentions is of the slightest precedential significance. Hence, they ignore the *Braden Copper* aspect of the decision, and the defeat to their position which it represents. But if the other California Courts follow that decision, the California Franchise Tax Board will be prevented by their own Courts, on local statutory and constitutional bases, from going worldwide. In that event, the treaty will deny them nothing which their own Courts would permit them to have.

The author of this Position Paper was the attorney who represented Chase Brass in the foregoing case, and he also represents a number of other taxpayers in litigation now pending in California Courts and administrative agencies, in which he is urging upon the California Courts that they follow the Braden Copper aspect of the *Chase Brass* case. Other attorneys are doing the same with their clients. It is possible that in at least some of the pending cases the issue wil be decided the same way it was in the Braden Copper instance, and California will lose in its own Courts, with the consequent necessity of making large refunds of taxes already collected. This will represent a fiscal burden to the State of California greater than any threatened by the treaty under consideration, because the California procedure does not permit a taxpayer to litigate a tax without first paying it. In consequence, every defeat the State suffers in its own Courts will result in a refund of taxes already paid into the State Treasury. The doubtful wisdom of a tax administration which is so suspect constitutionally and so stoutly resisted by taxpayers which may cause such gigantic drains on the State Treasury, through successful suits for refunds, would justify the Senate in questioning the wisdom of the advice that tax administration is giving it.

The *Chase Brass* case, involving Braden Copper Corporation, rejected California's attempt to consolidate and allocate by formula where the parent corporation was a U.S. corporation. Notwithstanding its defeat in those circumstances, the Franchise Tax Board has resolutely attempted to assert its sway over foreign parent corporations having U.S. subsidiaries which operate in California. One is reminded of Don Quixote. One of these is a client of the author of this paper, who has been given permission to reveal some of the facts presented in its case. The client is Capitol Industries–EMI, Inc., the stock of which is owned by a U.K. company, EMI Limited, which has operations directly or through subsidiaries in thirty-three countries. Capitol Industries is better known as Capitol Records. It records musical performances and spoken performances in the United States, makes phonograph and tape records from the tape masters of the performances, and sells the records to the public through distributors. Its specialty is pop and country music. It has a long-standing reciprocal licensing arrangement with EMI, under which masters of all of its recordings are available to EMI for the making of phonograph records for sale in the United Kingdom and Europe, and certain other countries, and in return EMI makes its classical repertoire available to Capitol, which presses records from it in this country and markets them under the names Angel and Seraphim. The arrangements clearly are of the type to be examined by the Internal Revenue Service under Section 482, Internal Revenue Code, and this examination has routinely occurred. The terms of the reciprocal arrangement have been in effect for twenty years and the working out of those arrangements has not been challenged in repeated audits under the Internal Revenue Code over that period. The State of California and the other states in which this corporation does business and to which it must pay taxes enjoy the benefits of the examination by the Internal Revenue Service, and if any unfairness to the United States in that reciprocal arrangement were uncovered by the Internal Revenue Service, each of those states would benefit accordingly, through parallel adjustments to the total U.S. income of the corporation.

This does not, however, satisfy California. It wants to force EMI Limited and Capitol into a consolidated unit, notwithstanding that EMI has numerous businesses of a type entirely foreign to and different from the record business of Capitol Records. For example, EMI Limited controls a television station in the U.K., which is the largest privately owned television station in that country; it owns and operates movie studios and a chain of cinemas; it owns and operates hotels and restaurants; it operates in the electronics field and has succeeded in developing the famed EMI brain scanner, which is being sold in the United States through another EMI subsidiary, which the Franchise Tax Board would consolidate with Capitol Records; it is a significant U.K. defense contractor. Under U.K. Law it would be guilty of treason as well as lesser offenses if it revealed any details, financial or otherwise, of those contracts to a political subdivision of a foreign power. The only unity which can exist between a U.K. defense contractor and an American phonograph record company, and between an American corporation which sells x-ray brain scanners and a subsidiary which makes and markets phonograph records, is unity of ownership. The Franchise Tax Board's theories of unity have now been reduced to where one unity is sufficient, if that one be unity of ownership.

The Franchise Tax Board wrote EMI in London asking that it make available to the Franchise Tax Board the type of all-revealing financial information it is accustomed to obtaining from taxpayers operating in California and other states. EMI replied to the Franchise Tax Board that the requested information was confidential and its revelation would be harmful to its interest; it pointed out that it had no permanent establishment in the United States and would no be expected to make such revelations to the U.S. tax authorities; it stated also that much of the information was not available to it, because it was not of the type which a British taxpayer would need and would accumulate; and finally, it stated that under both international law and the existing U.S.-U.K. treaty it was not amenable to the jurisdiction of the State of California and would not provide it with the requested information. The Franchise Tax Board asked Capitol Industries–EMI, Inc. to provide it with that information, and a letter from the American subsidiary to EMI Limited in London also failed to produce the information, the reasons given by the parent corporation to the request of the subsidiary being a reference to the refusal it had made when asked for the information directly by the Franchise Tax Board. The Franchise Tax Board then wrote both EMI and Capitol, threatening penalties if the demand for information was not complied with. Fortunately for all parties, sanity has subsequently prevailed with the Franchise Tax Board to the limited extent that the subsequently proposed assessment against Capitol did not assert penalties against it for its failure to force its parent corporation to accede to something the parent corporation had refused to do. The Franchise Tax Board has, however, issued a proposed assessment against Capitol Industries–EMI, Inc. without complying with the California statute which requires that the Franchise Tax Board supply the taxpayer, on request, with the details of the computation of allocated net income. Although Capitol has written the Franchise Tax Board asking that those details be supplied to it, the request has not yet been complied with. From the process of working backwards from the proposed assessment to the figures which are known to Capitol, which are the U.S. figures and those available in EMI's published reports, it appears that in the payroll factor the Franchise Tax Board has used a zero payroll figure for EMI's operations, although EMI's published reports reveal that it had more than 40,000 employees worldwide, and also revealed the payrolls in the U.K. The omission has the necessary mathematical effect of multiplying the percentage of the consolidated income which is allocated to California. Also, it appears that the property factor is improperly weighted in favor of California, apparently because rented property was included in the property factor only if it was located in the United States. A protest has been filed against this assessment, and undoubtedly Capitol will, in due course, learn the secret of the Franchise Tax Board's mathematics, but Capitol fully expects to learn that the Franchise Tax Board has taken the position that since EMI has been unable or unwilling to tell it what its worldwide payroll is, then it must be treated as having 40,000 employees work for nothing.

The response of EMI to the California demand for information may interest the Committee. The response was that the treaty between the United Kingdom and the United States binds each of the United States, whether taxing as a single state or as a national united government. This states the position the Senate should take, as the proposed treaty does: a commitment made by the United States should not be undermined by the individual States. The United States should consider what its own attitude would be if the United Kingdom should permit a local government with taxing power to be formed in Scotland and in Wales and should assert that the treaty limitations on the taxing power of the United Kingdom did not limit taxation by the government of Scotland or that of Wales. The United States would inevitably consider, we suggest, that the treaty had not been entered into in good faith in the first place if it could be so undermined.

On solid principles of international relations, the States should not be permitted to extend their reach to foreign countries in circumstances in which the United States by treaty has agreed not to extend its own. The spectacle of any State, and there are fifty of them that could do so, if permitted, demanding of a U.K.-based corporation doing no business in the United States that it make as complete a revelation of its internal financial affairs as it must to the United Kingdom government, is distinctly unbecoming. It is a burden on foreign commerce, and an affront to the dignity of the United States. For California or any other State to contend that burdensome demands for information and breach of confidentiality are necessary in order that the State protect its

taxation interest, when the United States government does not find it necessary to do likewise, stretches credulity beyond the breaking point. While each State is entitled to have its own concept of proper taxation and revenue administration, that is only within the confines of its own jurisdiction. Manifestly it has no jurisdiction to force EMI Limited to do anything at all. Its only hope is to resort to the subterfuge of imposing a tax on EMI's subsidiary which will be so heavy that EMI will find itself economically compelled to accede to the California demand. This is precisely what California is attempting to accomplish. Yet one cannot accept as being serious a contention that California must know the financial secrets of EMI's brain scan invention, and of its ability to operate a private television network in the United Kingdom in the face of the competition of BBC, or the cost and profits from defense sales to the Government of the United Kingdom, in order that California may determine how much net income Capitol Records makes in California from making and selling phonograph records.

In summary, forcing U.K.-based companies to reveal their financial secrets to the State of California is unnecessary to permit California fairly to enforce its tax laws. The Internal Revenue Service faces a similar problem, deals with it successfully, and makes the benefits of its operations available to California to apply for its own protection. California and the other States are all alike in this respect. None of them needs more protection than they already have, by virtue of the administration of Section 482 of the Internal Revenue Code by the Internal Revenue Service. To permit them also to roam the world threatening U.K.-based companies having no permanent establishment in the United States, demanding information which the United States would have no treaty right to demand, and generally acting like a bull in the international china shop, is unbecoming to the dignity of the United States, to the placidity of its relations with those countries with which it solemnly negotiates treaties, and accomplishes no purpose necessary for the protection of the revenues of the taxing States. If the treaty is objectionable in any respect, it is in the limitations of the protocol. It should be ratified, preferably without the protocol, but better with the protocol than not at all.

Finally, a comment should be made about Governor Brown's letter to Senator Sparkman. It is unlikely that the Governor is informed about the California court decisions discussed in this paper. They are obstacles in the way of the California tax authorities' efforts to force worldwide consolidation and apportionment on the portion of the world's business which has subsidiary operations in California. Until those obstacles are overcome, California's representatives are in the position of asking the Senate to let them persist in an effort to tax foreign income arbitrarily apportioned to California by an entirely mathematical formula, an effort their own Courts may well hold is violative of the United States Constitution.

EXTENSION OF TESTIMONY OF VALENTINE BROOKES, ESQUIRE BEFORE SENATE FOREIGN RELATIONS COMMITTEE ON ARTICLE 9(4) OF PROPOSED U.S.-U.K. INCOME TAX TREATY

Because of the necessary limitation on the time of the witnesses, some testimony which would have been given in response to the testimony of preceding witnesses had to be eliminated from the testimony of Valentine Brookes. Pursuant to permission granted by the presiding Senator, this extension of remarks is submitted.

1. Contrary to the statement of a witness representing the State Government of California, the California Legislature has not mandated the world-wide application of the unitary principal. In fact, the Legislature has not mandated the world-wide application of the unitary principal. In fact, the Legislature has not mandated the use of the unitary system at all. What the Legislature has done is to leave the choice of allocation method to the discretion of the Franchise Tax Board, and in its discretion the Franchise Tax Board has decided to employ the unitary apportionment system universally, and to go worldwide in its application. The phrase "worldwide" has been coined by the Franchise Tax Board, and means including foreign parents, foreign subsidiaries, and foreign operations of the taxpayer, as to net income and as to property, payroll and sales, in the net income to be allocated and in the factors used for apportionment. California has adopted the Uniform Division of Net Income For Tax Purposes Act, which is in effect in a majority of the states using the unitary

system. Its language in this respect is not different from the language adopted by the Legislatures of those states whose administrators have not construed it to go worldwide. It is as follows:

"§ 25101: Basis of allocation. When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120 of this chapter); provided, however, that any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not such transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.

"If the Franchise Tax Board reapportions net income upon its examination of any return, it shall, upon the written request of the taxpayer, disclose to it the basis upon which its reapportionment has been made."

"§ 25121: Application. Any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its net income as provided in this act."

"§ 25128: Business income. All business shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."

"§ 24137: Other apportionment methods. If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) Separate accounting; (b) The exclusion of any one or more of the factors: (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

The Senate will observe the absence of any provision requiring that the several corporations be combined, and all reference to foreign operations is omitted. Concerning the consolidated report, the Statute says:

"§ 25104: In the case of a corporation liable to report under this part owning or controlling, either directly or indirectly, another corporation, or other corporations, and in the case of a corporation liable to report under this part and owned or controlled, either directly or indirectly, by another corporation, the Franchise Tax Board may require a consolidated report showing the combined net income or such other facts as it deems necessary. The Franchise Tax Board is authorized and empowered, in such manner as it may determine, to assess the tax against either of the corporations whose net income is involved in the report upon the basis of the combined entire net income and such other manner as it shall determine to be equitable if it determines it to be necessary in order to prevent evasion of taxes or to clearly reflect the net income earned by said corporation or corporations from business done in this State."

Again the Senate will note the use of the word "may", which in the English language is understood to confer discretion and not a mandate.

2. Controller Cory stated that all of the cases on the subject sustained the inclusion of foreign operations in the unitary group. There are only two cases on this subject in the California Appellate Courts, and both are contrary to Controller Cory's statement. They are the Scandinavian Airlines case and the Chase Brass case, both cited in my position paper. The former case was discussed at length by Secretary Woodworth.

3. Article 9(4) is reciprocal, whereas legislation adopted by the Congress would not be. A legislative limitation on the states comparable to Article 9(4) would bind the states, but would not prevent foreign governments from permitting their political subdivisions to adopt identical methods of taxing American businesses operating in other countries through subsidiaries having permanent establishments there. The treaty route binds the other countries, and this can be of particular importance in those countries having a federal system. Among countries already having such a system are West Germany, Australia, Canada, Brazil, and Mexico. There is a parliamentary discussion of the adoption of some limited federal system in the United Kingdom, which might give Scotland, for example, a power of taxation, and that power, if conferred by the Parliament on Scotland, would be subject to the limitation of Article 9(4).

The United States, therefore, gains an important objective by having the provision adopted by the medium of the treaty, instead of pressing for legislation which would be exclusively unilateral in its limitations.

4. The states are utterly without constitutional support in contending that the treaty represents a "federal intrusion" into their sovereignty. The states are mere political subdivisions of the United States, and in the exercise of their limited sovereignty are subject to the following federal powers germaine to taxation: (1) The interstate commerce clause, which imposes limitations on state powers which in practice are administered exclusively by one branch of government, namely the Judiciary through the United States Supreme Court; the Constitution and the Court both recognize that Congress has the power to regulate commerce and any regulation it adopts supercedes any Court decision; failing legislation, which is the norm, the Supreme Court has adopted a set of rules, unilaterally. (2) The foreign commerce clause, which is adjunctive to the interstate commerce power, and may be articulated and enforced by the Supreme Court, the Congress, and also the Executive with the advice and consent of the Senate, through the treaty power. (3) The due process clause, which is customarily enforced by the Supreme Court, but has been, as it may be, also interpreted and enforced by statute.

It is therefore apparent that constitutional restriction on the powers of the states have been more often interpreted and enforced by a single branch, the Judiciary, than by any other branch of government, whereas in the treaty making power the limitation is the joint product of the Executive arm and the Legislative arm. The complaint of the states that there should be no "federal intrusion" on their power without the acquiescence of the House of Representatives is seen, therefore, to be an argument of desperation and without any merit. Finally, I referred in my testimony to the inappropriateness of any suggestion that a foreign nation should seek to make a treaty not with the United States but with the states in order to obtain limitations on their taxing structure, and I stated that such conduct had previously been thought to be unconstitutional. I did not cite the constitutional reference. Article I, Section 10, Clause 1 of the United States Constitution states:

"No State shall enter into any treaty * * *"

5. In my position paper I stated that the protocol limiting Article 9(4) to U.K. parent corporations, and omitting U.K. enterprises to which Article 9(4) would apply to those owned by U.K. shareholders, was in response to the objections of the states to the original provision. During their testimony, the representatives of the states were consistent and unanimous that they had not heard about the treaty before it reached the Senate, at which time that protocol had already been added. I therefore erred in stating that the protocol was in response to the objections of the states. Seemingly it was caused by the Treasury's own analysis, and was not placed in the exchange of notes in order to placate the American states. It certainly has not had that effect. If the Senate were to reserve, it therefore has even more reason for making its reservations against the protocol instead of Article 9(4). However, in view of the testimony of Secretary Woodworth about the probable effect of any reservation on action by the British Parliament, I do not urge the Senate to make any reservation at all.

I appreciate the opportunity of filing this extension of remarks, and urge the ratification of the treaty, without reservation.

Respectfully,

VALENTINE BROOKES.

Senator CHURCH. Our next witness is Charles M. Walker, who appears on behalf of himself, former Assistant Secretary of the Treasury for Tax Policy, Los Angeles, Calif.

STATEMENT OF CHARLES M. WALKER, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. WALKER. Thank you, Mr. Chairman.

I am pleased to appear to testify in support of the new United Kingdom Tax Treaty.

I am a lawyer residing and practicing in Los Angeles. I had the privilege of serving as Assistant Secretary of the Treasury for tax policy for about a year and a half, ending last January. One of the functions of my office was the negotiation of tax treaties. As a matter of fact, I had the privilege of appearing before this committee in November of 1975 to present testimony in support of new tax treaties with Iceland, Romania, Poland, and Russia.

The U.K. tax treaty had been negotiated before I came to the Treasury. However, it was signed soon thereafter, and quickly drew criticism from California because article 9, paragraph (4) of the treaty impacted on the unitary tax system of California. Indeed, responsive to California's complaints, restrictive material was included in a 1976 exchange of notes between the United States and the United Kingdom. Even with that exchange, however, the California State tax authorities have continued their opposition.

I should note here, Mr. Chairman, that while my firm represents clients who may be affected by the United Kingdom treaty, my presence before this committee is solely my own personal endeavor. I am not speaking on behalf of any specific client or business group. I am speaking, however, both as a resident of California and as a former Treasury official. As a resident of California, I support efforts made to protect the legitimate revenues of the State through use of appropriate tax laws. As a former Treasury official, I feel it is necessary to put California-oriented concerns into perspective with overriding national interests.

CALIFORNIA'S OBJECTIONS TO ARTICLE 9(4)

California objects to article 9(4) because that article would prohibit it from applying its unitary tax system to the worldwide activities of a U.K. enterprise of which the California activities are only a part.

It is entirely appropriate, of course, for a State to protect its tax revenues by looking through the tax-avoiding manipulation of business and financial transactions among members of affiliated groups and by fairly measuring its tax base.

In that respect, as a resident of California I applaud the State's efforts. But when this is done by applying the unitary system to foreign operations, particularly those controlled by foreign enterprises, it is harmful to the national interest and should be prevented. Article 9(4) solves the problem, at least as far as United Kingdom enterprises are concerned.

HARM IN APPLYING STATE'S UNITARY SYSTEM TO FOREIGN OPERATIONS

The important point to grasp is that the national interest is definitely harmed by the application of a state's unitary system to foreign operations. This is because that system disrupts implementation of the Nation's policy of harmonizing, through our network of bilateral tax treaties, our country's tax system with the tax systems of our treaty partners. This harmonization is essential: first, if we are to minimize the double taxation of income derived from operations in both countries; second, if we are to assure the efficient admin-

istration of our revenue laws which mutually affect taxpayers of the U.S. and of our treaty partner; and, third, if we are to provide a desirable tax climate for job-creating foreign investment in the United States.

Tax treaties have many elements in common which reflect certain internationally accepted concepts. One of these is that transactions among members of commonly controlled organizations can be recognized for tax purposes only to the extent that they are on an arm's length basis. A mechanism is established in the treaties for the audit of tax returns on that arm's length basis, recognizing, however, the integrity of separate corporations in terms of their primary liability for taxes in one of the treaty partner countries.

No unitary method whether employed by California or any other state is used for either federal or foreign tax purposes. Thus, if California's use of the unitary method produces an income base which exceeds the amount determined on a separate corporate and arm's length basis, then necessarily (assuming California is the only state in which U.K. operations are conducted) California will be taxing foreign source income as that term has been defined and recognized internationally for federal and foreign income tax purposes. In the context of harmonizing international tax systems among tax treaty partners, this is an unacceptable development.

Given the increasing values and geographic dispersion of multinational business activities, and given the awareness by the Treasury of the accelerating force with which California has been applying its unitary system to worldwide operations, it is to the Treasury's credit that it has, by including article 9(4) in the U.K. treaty, brought to the Senate this further opportunity to assert the federal prerogative over international tax relationships.

Those relationships have a direct bearing on the conduct of foreign trade, on the balance of payments, on foreign investment in the United States, and, indeed, on international relations.

Without a constraint such as article 9(4) provides, any or all of the 50 States could apply their own brand of unitary tax to worldwide operations of companies doing business in their state. This would lead to untold confusion, to an unascertained amount of double taxation, and to a substantial interference in meeting the national concerns I have mentioned.

Our treaty partners and taxpaying entities in their jurisdiction understandably complain that application of the unitary system to their worldwide operations produces excessive tax burdens on their U.S. operations, and entails unwarranted interference with their non-U.S. operations through demands for information and record keeping not otherwise required by their foreign operations.

It is most important, therefore, to maintain the exclusivity of Federal direction with respect to the taxation of foreign source income, and to assure that no state's tax base can take into account foreign operations inconsistently with the internationally accepted norms reflected in our tax treaty network. Thus, article 9(4) is a wholly proper measure for the Federal Government to adopt and is well within established legal precedent. While Federal legislation might properly be addressed to the same issue, it still would be necessary to have provisions similar to article 9(4) in our tax treaties,

if our trading partners are to be reciprocally bound and are to be assured that the legislation will not be unilaterally changed to their detriment.

GOVERNOR BROWN'S POSITION

Mention was made by Mr. Cory here this morning of a meeting in Sacramento on the 12th of this month. I attended that meeting. I, too, heard what the representatives on Governor Brown's staff have said with respect to the unitary system and the question that was put with respect to Governor Brown's own position on this.

As I recall, the response was that the letter that Governor Brown had written had been written some time earlier before he was as fully aware as he now is of the impact of the unitary system. I think the Governor has not publicly taken a position contrary.

As a Californian, I have a very close interest in watching developments. At this moment, I would say the jury is still out. There is a decided heaving and hauling between the tax administration and the tax policies that the Brown administration would like to present. I cannot say any more than that on that subject.

UNITARY SYSTEM NOT UNDER ATTACK

I might add that the unitary system which has been referred to so many times is not really under attack here at all. It is the application of the unitary system to foreign operations that is under attack. The California statute does not mandate the application of the unitary system to foreign operations. It merely permits it. The administrative process by which it is being utilized does impact on foreign operations.

I think the Federal Government clearly has the power to and should prohibit application of a State's unitary tax system to worldwide operations if such application can reasonably be viewed as interfering with the conduct of foreign commerce. For reasons already stated, it is clear that there is such interference and it follows that the prohibition should be invoked.

States' rights are not infringed by article 9(4). The role of the Federal Government in negotiating tax treaties is unquestioned. The fact that article 9(4) constrains some states' tax action is not a unique occurrence, as the authorities already referred to have stated. As other witnesses have stated, if article 9(4) is reversed, the entire treaty will have to be renegotiated. There also will be complications involved in dealing with still other treaties.

CONCLUSION

In conclusion, I urge that the committee recommend that the treaty be ratified with article 9(4) in it and that the concerns of the State of California and other States are not serious enough to warrant reservation of article 9(4) from the treaty. To do so would deprive the Nation as a whole from the benefit of that article and from a new U.K. treaty itself, at least for an indefinite period of time.

Thank you.

[Mr. Walker's prepared statement follows:]

PREPARED STATEMENT OF CHARLES M. WALKER, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. Chairman and members of this distinguished committee: I am pleased to appear here today to testify in support of the new income tax convention with the United Kingdom.

First, let me introduce myself. I am a lawyer residing and practicing in Los Angeles, California. I had the privilege of serving as Assistant Secretary of the Treasury for Tax Policy from early September, 1975, to January 20, 1977. One of the functions of my office was the negotiation of tax treaties and the preparation of treaty documents, protocols thereto, and notes exchanged thereon for signature by appropriate officials of our government. As a matter of fact, I had the privilege of appearing before this Committee on November 7, 1975, to present testimony in support of new tax treaties with Iceland, Romania, Poland, and the Union of Soviet Socialists Republics.

The income tax convention with the United Kingdom (which I will refer to as the United Kingdom Tax Treaty) had been negotiated before I assumed my duties with the Treasury Department. However, signature of the Treaty occurred thereafter, as did the exchange of notes thereon dated April 13, 1976. In connection with these latter activities, I became acquainted with the terms of the Treaty. Soon after it was signed, it began to draw criticism from the California tax authorities because of the impact of Article 9(4) of the Treaty on the unitary tax system of California. Indeed, responsive to comments made by the state tax authorities, relevant material was included in the exchange of notes dated April 13, 1976. Even with that exchange, however, California state taxing authorities have continued their opposition to Article 9(4).

I should note here, Mr. Chairman, that while my firm, Paul, Hastings, Janofsky & Walker, represents clients who may be affected by the UK Treaty, my presence before this Committee is solely my own personal endeavor. I am not speaking on behalf of any specific client or business group. I am speaking, however, both as a resident of California. I support efforts made to protect the legitimate revenues of the state through use of appropriate tax laws. I am concerned, however, that use of those laws, allegedly to *prevent* a revenue loss will instead be counter-productive, and that in the long run, use of those laws will *produce* a far greater revenue loss. As a former Treasury official, I want to put California-oriented concerns into perspective with overriding national interests.

Perhaps the most significant and precedent-setting aspect of the UK Treaty is the provision concerning the crediting of the UK advance corporation tax (ACT) to shareholders of UK corporations who are direct investors as distinguished from portfolio investors. This is a highly significant provision and which serves as a precedent for similar provisions in other tax treaties designed to remove the discrimination against US. investors in corporations of the treaty partner country. Article 9(4), however, has produced the greatest amount of controversy and it is that provision to which my comments will be addressed. While that article will apply uniformly to the federal government and all the states and political subdivisions or local authorities therein, the following discussion will illustrate its application to California, since California is the principal objector to the article.

Article 9(4) has practical effect upon a subsidiary of a UK parent corporation doing business in California. In effect, it provides that in taxing the income of the subsidiary, California cannot take into account the "income, deductions, receipts or outgoings" of the UK parent corporation or any of its other subsidiaries which are not residents of the U.S. The exchange of notes to the Treaty makes clear that Article 9(4) will not apply if the UK parent is a U.S. controlled corporation, or is a corporation organized under the laws of the U.S. or of a third country, or is controlled by a corporation which is a resident of a third country. Objection to Article 9(4) is made by California because California is currently doing that which Article 9(4) would prohibit. It does this by applying its unitary tax concept to the worldwide income of the enterprise of which the California activities are a part. In this respect, California is extending to foreign operations the unitary tax approach which it pioneered some years ago when the focus had been simply on operations conducted within the various states of the nation.

The unitary concept was designed as a response to the tax planning by commonly controlled domestic corporations conducting business in more than

one state to utilize transfer pricing and other inter-company transactions in order to concentrate profits in states with low corporate income taxes. The California response was to require such a commonly controlled corporate taxpayer doing business in California to file a "combined report" setting forth not only its own total net income, properties, sales and payrolls, but also such data for any out-of-state corporate affiliates which participate in the same unitary business as the California taxpayer. California then applied a non-price oriented formula to the combined net income figure, that is, a formula based on the relative amounts of property, sales and payroll within and without California, thereby allocating to California a fraction of the affiliated group's combined net business income. With the advent of multinational corporate activity, the unitary approach was extended to worldwide activities, as well as activities within the U.S.

It is entirely appropriate, of course, for a state to protect its tax base and its tax revenues by looking through the tax-avoiding manipulation of business and financial transactions among members of affiliated groups. In that respect, as a citizen of California I applaud the state's efforts in this regard. That is not to say, however, that I endorse the application of the unitary system to all the situations to which the California tax authorities apply it. Indeed, I question use of the system for the combined reporting of distinctly separate, albeit commonly controlled, operations, as, for example, the manufacture and sale of widgets as one operation and the operation of a hotel as another. This is objectionable enough when applied to businesses conducted solely in the United States. It becomes highly repugnant when applied to business done in foreign countries.

I will now develop the rationale for supporting Article 9(4) of the UK Treaty against the assertion which I assume the California tax authorities will make, that it is an inappropriate, unwarranted and perhaps illegal or unconstitutional interference with a state's right to determine its own tax base by extending application of the unitary system beyond operations in the United States so as to include foreign operations as well.

A. THE AFFIRMATIVE CASE—HARMONIZATION OF INTERNATIONAL TAX SYSTEMS

The United States has a network of over thirty bilateral tax treaties with different countries. Each of these has been negotiated bilaterally and has been ratified by the United States Senate. Negotiation for the U.S. has been conducted by the Treasury Department whose principal concerns have been the harmonization of the tax system of the U.S. with that of our treaty partner to minimize the likelihood of double taxation of income derived from operations in both countries and to assure the efficient administration of the revenue laws of the U.S. and our treaty partner.

Obviously, to whatever extent a U.S. enterprise is subjected to double taxation with respect to its overseas activities, it is prejudiced in maintaining a competitive position with enterprises of other nations. And it is axiomatic that tax audits in the two countries must be fairly conducted so that neither the taxpayer nor either of the treaty partner countries in which it operates will be whip-sawed in the taking of positions that affect either the taxpayer's tax liability or the country to which it is owed.

It, thus, is of national concern from the standpoint of protecting the revenue and from the standpoint of protecting the country's corporate citizens to achieve the highest possible degree of harmonization of international tax systems. This is done through the mechanism of bilateral treaties.

Tax treaties have many elements in common which reflect certain internationally accepted concepts. One of these is that transactions among members of commonly controlled organizations can be recognized for tax purposes only to the extent that they are on an arm's length basis. A mechanism is established in the treaties for the audit of tax returns on that arm's length basis, recognizing, however, the integrity of separate corporate organizational structures in terms of their primary liability for taxes in either of the countries which is a party to the tax treaty. A mechanism also is established for the resolution of disputes in the reaching of tax audit results, utilizing in this respect the mechanism of "competent authority" in each of the treaty countries. Thus, a designated official of the IRS and his opposite number in the other country, each of whom is identified pursuant to the Treaty as the "competent authority", are able to resolve issues that may arise as to the country in which to tax, and

the basis upon which to tax, income from tax-realizing transactions which occur in their two countries.

Coincident with the arm's length rules and the recognizability of separate corporate entities is a concept, also implicit in the tax treaties, of so-called source rules—that is rules for determining whether and to what extent income from multinational operations is, for tax purposes, to be considered as derived from sources within the U.S. or from foreign sources. A mechanism exists at the federal level, therefore, for determining the amount of foreign source income. The tax treaties in conjunction with federal internal revenue laws determine the extent, if any, to which the foreign source income is taxable for federal tax purposes. Thus, a U.S. subsidiary of a UK parent corporation doing business in the U.S. cannot subject the UK parent to U.S. income tax except to the extent of its U.S. source income as that has been articulated in the UK Treaty. The separate corporate entity of the subsidiary is recognized and its tax liability is separately calculated through utilization of the arm's length techniques mentioned above.

The unitary method employed by California is not used for federal or foreign tax purposes. Thus, if California's use of the unitary method produces an amount of taxable income for the subsidiary which exceeds the amount determined on a separate corporate and arm's length basis, then necessarily (assuming California is the only state in which U.S. operations are conducted) California will be taxing foreign source income as that term has been defined and recognized internationally for federal and foreign income tax purposes. In the context of harmonizing international tax systems among tax treaty partners, this is an unacceptable development.

Given the increasing values and geographic dispension of multinational business activities, and given the awareness by the Treasury of the accelerating force with which California reputedly has been applying the unitary tax method to worldwide operations, it is to the Treasury's credit that it has, by including Article 9(4) in the UK Treaty, asserted the federal prerogative over international tax relationships. Those relationships have a direct bearing on the conduct of foreign trade, on the balance of payments, and, indeed, on international relations.

Provisions similar to Article 9(4) can, and undoubtedly will, be included in other tax treaties in due course, assuming the UK Treaty is ratified with Article 9(4) included. Without such provisions and if any or all of the fifty states impose their brand of unitary tax on worldwide operations of companies doing business in their state, there would be untold confusion, an unascertained amount of double taxation, and a substantial interference with meeting the national concerns noted above. From the standpoint of protecting the national revenue, the federal government is deeply concerned whether the tax liability of a multinational enterprise is paid to the U.S. Treasury or to the treasury of another country. To that end, it monitors the administration of the relevant tax treaties, including the application of the arm's length separate entity concept in the measurement of taxable income. The federal government does not have the same concern with respect to whether the state tax liability of a multi-state enterprise is paid to state A or to state B, and is not involved with monitoring the measurement of domestic interstate income.

It follows that the national interest of protecting the federal revenue and foreign trade is not affected by a state's use of the unitary method in connection with purely interstate operations. But it is vitally and adversely affected when that method is used in connection with foreign operations. Treaty partners and taxpaying entities in their jurisdiction can rightfully complain of excessive tax burdens imposed on their U.S. operations, and of unwarranted interference with their non-U.S. operations through demands for information required for the application of the unitary system to worldwide operations. It is most important, therefore, to maintain the exclusivity of federal direction with respect to the taxation of foreign income, and to assure that the state tax base involving foreign source income not be inconsistent with the internationally accepted norms which are specifically utilized by our tax treaty network. Article 9(4) is a wholly proper measure for the federal government to adopt and is well within established legal precedent. See the authorities cited below in part D, page 26.

The fact that the unitary system has been approved judicially with respect to domestic activities within the U.S. is not precedent for approving its use

to include overseas activities. The fact is that impact of the unitary system upon foreign commerce has been specifically addressed by federal authorities and in that respect the states have been preempted from engaging in an income tax practice which affects foreign commerce. The preemption is evidenced by the tax treaty network. Inclusion of Article 9(4) in the United Kingdom Tax Treaty is but a further refinement of that preemption, made in view of the currently growing volume of activitity by multinational corporations and the application thereto of the unitary tax system.

To require that a state's tax base involving foreign source income not be inconsistent with the internationally accepted norms utilized by our tax treaties does not impugn the viability of a unitary system applied to U.S. source income. While this subject is beyond the scope of these remarks on the UK Treaty, indeed beyond the scope of remarks on other tax treaties which may yet include provisions similar to those contained in Article 9(4), the fact is that even here the unitary system is under close scrutiny, if not attack. The simplistic example, referred to above, is the multi-state enterprise which manufactures and sells widgets, and also operates a hotel. Is there justification for unitizing those operations?

This subject has received much congressional attention over the years. See State Taxation of Interstate Commerce, H.R. Rep. No. 1480, 88th Cong. 2d sess. (1964); Hearing on S. 1245 "Interstate Taxation Act of 1973" before subcommittee on "State Taxation of Interstate Commerce" of the Senate Committee on Finance, 93d Congress, 1st sess. (1973); S. 2080, "Interstate Taxation Act of 1975" 94th Congress, 1st sess. (1975). See also Essays in International Taxation: 1976, Tax Policy Research Study Number Three, Treasury Department, p. 231 "State Taxation of Corporate Income From Foreign Sources".

The most recent attention to this subject was given by the Ways & Means Committeee task force on foreign source income. Hearings of the task force were attended by tax authorities of California and Oregon who presented to the task force their views on the subject. Notwithstanding those views, the Task Force report forcefully noted serious problems with the unitary system where applied to foreign operations. See Recommendations of the Task Force on Foreign Source Income, Committee on Ways and Means, March 8, 1977 pages 28–30.

B. REVENUE IMPACT

It has been asserted that California will suffer a substantial revenue loss if the UK Treaty is ratified with Article 9(4) included in it. Passing for the moment the way in which the revenue loss has been estimated, one could approach the revenue loss matter by saying that a loss cannot be properly classified as a loss if there was no entitlement to the money in the first place. In view of the federal preemption of the field of harmonizing the international taxation of foreign source income, one might wonder at the extent to which California's unitary system was properly applicable to foreign source income even before Article 9(4) of the UK Tax Treaty highlighted the issue. Indeed, it may very well be that some of the revenue, the loss of which is asserted to arise, may already be the subject of litigation which has yet to be concluded.

Coming now to the computation of the amount of the revenue "loss", it would be important to isolate several elements in the computation. First, there should be shown the amount attributable to application of Article 9(4) of the UK Tax Treaty itself. Second, there should be shown the amount which may be attributable to the assumption that provisions similar to Article 9(4) will be simultaneously invoked as though they had in fact simultaneously been made effective in all the other relevant foreign tax treaties, that is those with countries in which operations exist with respect to which California has been, and presumably would continue, to apply, the unitary principles. Third, there should be shown the amount attributable to the operation of Article 9(4) principles to foreign operations by non-California U.S. parent corporations which have operations in California and abroad, whether through branches or subsidiary corporations. Fourth, there should be shown the amount attributable to the application of Article 9(4) principles to foreign operations by California parent corporations which have branch or subsidiary operations overseas and possibly in other states. Fifth, and finally, there should be shown the amount involved, if any was included in the revenue loss estimate, in applying the separate entity arm's length approach as distinguished from the unitary approach to

all domestic U.S. operations alone in situations where there are no overseas operations.

It is my understanding that California has estimated the revenue loss to be $125,000,000. It is also my understanding that in making that estimate, it has been assumed that the principles of Article 9(4) were applied in the first four circumstances just mentioned, and that a separate estimate was not made for each circumstance, nor of the amount of tax that will turn on issues presented in pending litigation relating to those circumstances. The California tax authorities thus have involved this Committee and the United States Senate, through solicitation of regard for the revenue loss, in the decisions the California tax administrators or legislators may some day make in response to the inclusion of Article 9(4) in the UK Treaty, and in the decision California courts may make in pending litigation on these tax issues. This is not a proper involvement. Nor is it relevant to the present inquiry to consider, as among the various corporations affected by Article 9(4), which of them will be gainers and which will be losers from the application of Article 9(4) to the California tax system.

While a revenue loss to California is obviously of concern, it is not clear what the role of this Committee or of the United States Senate should be in considering that matter. If the existence or non-existence of a revenue loss is relevant to ratification of the Treaty with Article 9(4) included, it would seem appropriate to schedule hearings specifically on the matter to ascertain the validity of the revenue estimates. Such evidence would include inquiry into matters mentioned above. In addition, it would include evidence with respect to all relevant economic factors, such as the effect of the unitary tax system upon the attraction to California of new business and the willingness of California enterprises to expand within California. Each of these factors has an impact upon the California tax base for purposes of the income tax, real property tax, personal property tax and sales tax, relating not only to corporate activity, but also to the resulting increase in employment, payroll, and consumer purchasing power. These kinds of analyses would appear to be beyond the scope of this hearing. Accordingly, it would seem appropriate to disregard for these purposes the amount of a California revenue loss. The $125,000,000 figure should be regarded with no more concern than could figures of equal or larger size with respect to the adverse impact on the California economy generally occasioned by the disincentive to business attraction and expansion due to the California unitary system. In this respect, one can take note of recent press accounts following California Governor Brown's recent experience in learning of the disinclination of certain Japanese industries to locate facilities in California, largely because of the anticipated application of the unitary tax system.

C. ADMINISTRATIVE PROBLEMS

Application of the unitary system to worldwide activities requires in the first instance a determination of which corporations or parts of corporations of a controlled group should be deemed interdependent with the California taxpayer. To the extent this is left to the discretion of the California tax authorities without benefit of established rules, regulations or guidelines, it is not possible for an enterprise contemplating activities in California to know whether it will provoke application of the unitary system or not. It is unreasonable to inflict such uncertainties upon taxpayers.

In fact, because California is subject to constitutional requirements of due process, a definition of the unitary entity as applied to foreign source income is a prerequisite, and one that is not supplied simply by applying the definition used for domestic U.S. operations. If the definition of a worldwide unitary enterprise is overly broad, it creates a significant potential for misallocation, since it involves a great risk of improperly allocating to a certain country income clearly earned in another. Yet unless a broad definition is adopted, one of the major advantages of the unitary method is diminished. Thus, while the unitary entity theory, as opposed to the separate entity, arm's length method, has the advantage of eliminating the need for taxpayers or tax authorities to locate comporable arm's length data for what may be a large volume of intercompany transactions, this advantage may be offset by the need and uncertainty, and potential inequity of making case-by-case determinations of the boundaries of the unitary business when compiling and auditing various combined reports.

Problems of compliance with the unitary method applied to foreign operations can be extremely burdensome. The taxpayer not only must file data con-

eerning its own operations, but must include data concerning sales, payroll and property of legally separate corporations. The costs of obtaining and processing the data concerning a large enterprise in order to determine the taxable income of one small part of it, in California, for example, can easily be excessive, especially when different accounting systems are used abroad.

Moreover, there is the question whether California can compel a subsidiary to produce for inspection the business records of separately incorporated foreign parent and affiliated companies. It is hardly satisfactory to substitute for those records conclusions drawn from financial data in published reports, yet that approach is reputedly used, leaving the taxpayer with no choice but to take a resulting tax assessment which at least borders upon, if it is not in fact, an arbitrary assessment, and one which the taxpayer has no practical capacity to contest.

Then there is the problem of assigning values to the formula variables and attributing property, sales or payrolls to the proper country. For one thing, the burden of case-by-case appraisal of a company's worldwide assets can be horrendous. For another, the weighting of property and payroll factors could very reasonably differ from country to country in terms of the contribution each factor plays in determining a profit for worldwide activities. For example, how should the value of a shoe factory in Korea be equated with the value of a warehouse in California? How should wages of production workers in Malaysia be equated with salaries of office personnel in California?

Moreover, use of the separate entity and arm's-length method by the federal tax authorities (consistently with provisions in our many tax treaties), if not also used by the states in connection with foreign source income, can lead to double taxation of that income. While double taxation at the national level is largely avoided by application of tax treaty rules, it will exist at the state level if the state's tax base is enlarged to include foreign source income not included in the federal tax base. This can be particularly troublesome where a foreign government may question the composition of a formula unilaterally selected by California: a capital-poor country, for example, might not recognize the use of a formula that weighs the capital variable heavily. Finally, in individual fact situations in which a country believes that is has a particularly strong claim to tax certain items of income, it may be unwilling to recognize the use of a formula that would allocate any portion of this income elsewhere.

The risk of double taxation of foreign income under the unitary theory increases the cost of doing foreign business through entities subject to California taxing jurisdiction and could serve to make American businesses uncompetitive with their non-American counterparts. In addition, if an allocation formula composed of property or payroll variables is adopted, California tax liability could be reduced by shifting assets out of California, possibly abroad, and hiring foreign labor, raising the proportion of foreign factors in the formula, and reducing California's share of the tax base. These factors could provide significant incentives to move business outside of California.

D. THE DEFENSIVE CASE

It can be expected that state tax authorities will include the following points in arguing that Article 9(4) should be reserved from the UK Treaty:

1. The unitary method is simpler to administer than the arm's length, separate entity approach, and produces equitable results.

2. The federal government should not, even if it has the authority, prohibit the states from using the unitary system on a worldwide basis if they choose to use it.

(*a*) It is unwise political policy.

(*b*) It has an adverse impact on states' revenues.

(*c*) It is an infringement on states' rights.

3. Even if the federal government does prohibit the states from using the unitary system on a worldwide basis, it should do so through a legislative process, not through the treaty process.

DISCUSSION

1. It simply is not true to say that the unitary method is simpler to administer than the arm's length separate entity approach, and that it produces equitable results.

If the unitary system is to be fairly administered, and not arbitrarily applied to worldwide operations, it will be necessary for the state tax authorities to do more than merely demand the presentation to them of evidence to substantiate the net income and property, payroll and sale figures of worldwide operations. Merely to make the demand and to check the material supplied may be simpler than to work with the factors necessary to determine arm's length transaction tests between related entities. But that does not really address the issue.

To obtain reliable data on worldwide operations entails the following:

(*a*) The state taxpayer must be able to obtain the data. This is frequently not possible, particularly where the taxpayer is engaged in an activity which is distinct from worldwide activities of its parent company and may be a small part of the parent's worldwide activities. The parent may refuse access to the data, may indeed be prohibited by its governing law from providing it.

(*b*) Accounting concepts vary from country to country. To harmonize them in order to produce a uniform base upon which to apply the unitary system could be a difficult task, and completely non-productive for any but state tax determination purposes. Differences can exist, for example, with respect to the tax effect of reserves, of cost recovery techniques and depreciation practices, allowability of various expense deductions, inventory valuation techniques, etc.

(*c*) Property valuation questions abound. Property ownership concepts vary from country to country—outright ownership, leased rights, license rights, etc. Is valuation measured by book values (what depreciation adjustments are appropriate), fair market values, tax assessor's values? How are inventory values measured? What is the impact of contingent rights and liabilities—work in process, progress payments, production facilities under construction, etc.? Is value taken at year end, beginning, average during the year?

(*d*) Payroll problems also abound. What is the impact of pension and profit sharing payments, government programs, and fringe benefits of all sorts?

(*e*) Sales figures will vary according to the standard used to determine where the sales occur—place of contract, place of production, place of delivery, port of debarkation, port of entry? Relevant data simply may not be in existence.

(*f*) How will fluctuating monetary exchange rates be handled, particularly where there are transactions among foreign entities? That this is an extraordinarily complex problem is evidenced by detailed rules of the federal tax system. Reg § 1.964–1(d).

(*g*) How will adjustment be made to reflect payment of foreign income taxes? If the three factor formula is applied to worldwide net income, it would have to be after-tax income or double taxation will result.

Questions abound, therefore, in determining, country by country, which taxes are income taxes—a question that has long plegued the federal government in applying rules for crediting payment of foreign taxes against the U.S. tax liability.

How can it possibly be simpler to grapple with the above problems than to work with the internationally accepted norm of an arm's length separate entity approach? Indeed, since the federal government is involved in the application of the arm's length test in the national interest of protecting the federal revenue, it would be in the state's best interest simply to piggyback on the work of the federal tax auditors. That is the simplest of any route for the states to follow.

The only way the unitary method can possibly be considered simple is by assuming that the state tax authorities will merely ask for the relevant data concerning foreign operations and will conclude from what they get, or do not get, the amount of the combined income to tax, relying to the extent they choose to do so, upon publicly available information concerning the combined enterprise, whether or not that information was prepared responsively to the issues involved in applying the unitary system. If that is the standard of simplicity that recommends use of the unitary method, that method manifestly cannot produce equitable results. On the contrary, such use of the unitary method is both arbitrary and unreasonable, and restraint of its use by Article 9(4) should be commended.

2. The federal government clearly should prohibit the states from applying the unitary tax system to worldwide operations if such application can reasonably be viewed as interfering with the conduct of foreign commerce. The affirmative case set forth above shows clearly that there is such interference. It follows that the prohibition should be adopted, despite the political policy argu-

ment that the federal government should desist from action that affects a state's choice of its tax system. Ruffled feathers of a state cannot be allowed to interfere with a needed and proper exercise of federal action.

Impact of Article 9(4) on California's tax revenues was discussed above in part B. It can be restated here simply that one could hardly consider a revenue loss to occur from the non-collection of taxes if there was no entitlement to the tax money in the first place. Reference should be made to part B for the reasons California's alleged revenue loss has not been substantiated.

States rights are not infringed by Article 9(4). The role of the federal government in negotiating tax treaties is unquestioned. The fact that Article 9(4) constrains some state tax action is not a unique occurrence. There is ample precedent for it. The following cases are in point: *Kolovrat* v. *Oregon*, 366 U.S. 187 (1961); *Clark* v. *Allen*, 331 U.S. 503 (1947); *Nielsen* v. *Johnson*, 279 U.S. 47 (1929); *Missouri* v. *Holland*, 252 U.S. 416 (1920); *Hauenstein* v. *Lynham*, 100 U.S. 483 (1880); *Ware* v. *Hylton*, 3 Dall. (U.S.) 199 (1796); *Scandinavian Airlines System* v. *Los Angeles*, 56 Cal. 2d 11, 363 P. 2d 25 (1961).

3. A Federal statute broadly aimed at the situation which is narrowly addressed by Article 9(4) of the UK treaty would certainly be appropriate. But that is not to say the narrow application of Article 9(4) only to UK controlled enterprises is inappropriate. Rather it is a perfectly logical provision to include in a bilateral tax treaty. The subject is germaine to the treaty, is confined to UK enterprises, and is within the proper scope of federal action. Parties concerned with the treaty have their "day" in which to express opposition through the mechanism of this hearing, with as much effectiveness as if the matter were handled in a normal legislative manner.

E. CONCLUSION

It clearly is in the national interest to ratify the UK treaty, including Article 9(4), and I urge this committee to recommend that it be so ratified. The concerns of the state of California and other states are by no means serious enough to warrant a reservation of Article 9(4) from the treaty, and thus deprive the nation as a whole from the benefits of that article.

I thank the Committee for its attention.

[The following information was subsequently supplied:]

PAUL, HASTINGS, JANOFSKY & WALKER,
Los Angeles, Calif., July 29, 1977.

Re United Kingdom Tax Treaty.

Senator JOHN SPARKMAN,
Chairman, Committee on Foreign Relations, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR SPARKMAN: At the hearing of your Committee on the above matter July 20, Senator Church stated that the record would be kept open for two weeks in order to receive supplemental material appropriate to the issue.

There are four topics upon which I would like to elaborate as a supplement to my written statement herefore submitted and to my oral remarks made on July 20.

1. Unitary tax system of the States is not seriously impaired

There was lack of clarity at the hearing with respect to the effect of Article 9(4) of the UK Treaty upon the unitary tax system employed by some of the states, particularly California. Article 9(4) simply puts an outer limit on the extent to which the unitary system can be applied, but in other respects has no effect whatsoever upon the states' unitary system. Thus, a UK parent company with one or more U.S. subsidiaries which, for example, operate in all fifty states, will find that even with Article 9(4) in place the unitary system can continue to apply to the subsidiaries' operations in all fifty states. It is only the operations of UK subsidiaries in other countries (or in the UK itself) that are excluded from the California unitary system.

It will be most interesting to see the extent to which states other than California apply the unitary system to operations outside the United States of foreign controlled or even domestically controlled enterprises. The California State Controller, Mr. Cory, very clearly wished to give the impression that thirty-one states were doing this, not only California, Oregon and Alaska. Senator Javits

quite correctly pressed for clarifying evidence. To the extent other states, although applying the unitary system to U.S. operations, are not applying it to foreign operations of United Kingdom controlled enterprises, Article 9(4) would have no impact whatsoever. Nor could there be any impact on the unitary system of these other states if provisions similar to Article 9(4) were included in other tax treaties if those states were not applying the unitary system to foreign operations generally. I would like the opportunity to comment upon the evidence Mr. Cory presents to the Committee on this subject.

In my oral remarks I stated my understanding to be that the California unitary tax system did not mandate or require, but merely permitted, the application of the unitary system to foreign operations. I have confirmed that impression by a review of the applicable California statutory provisions. Copies of the relevant statutes are enclosed as Exhibit A. You will see that nothing in the statute requires application of the unitary system to any foreign operations. Indeed, it specifically leaves room for the California Franchise Tax authorities to conclude that consistently with federal policies and practices an arm's length, separate accounting approach would be appropriate for foreign operations. Thus, the inclusion of Article 9(4) in the UK Treaty has no direct bearing upon the applicable California statutes. Those statutes can remain completely in place just as they are. All that will be occurring is that the administrators of those statutes can no longer apply the unitary system to foreign operations of UK enterprises.

2. Disincentive effect has national implications

There was much material presented at the hearings in both written and oral statements to the effect that the unitary system applied to foreign operations of foreign enterprises is a disincentive for business to come to California (or to remain or expand therein), thus harming California's economy, and that this detriment outweighs the alleged revenue loss that is said to arise if Article 9(4) is included in the UK Treaty.

This is not simply a California problem to be dealt with by a change in the California statute or administrative practice. Rather, it is a national problem.

If Article 9(4) is reserved from the UK Treaty, it will be an open invitation to other states to extend their unitary tax system to foreign operations. Indeed, the capacity to do so is the principal point urged by the representatives of the Multi-State Tax Commission and representatives of other state taxing authorities. A unitary system, if extended by all fifty states to foreign operations, would have a very serious adverse effect on the entire body of job-creating foreign investment in the U.S. This clearly is a national problem. The disincentive to a business going to or remaining in State A cannot be overcome from the standpoint of the nation's best economic interest, simply by assuming that business will go instead to State B. By hypothesis, each of the other states is expected to have (or be able to have) a unitary tax system applied to foreign operations that will be equally disadvantageous. Now is the time to address this subject. The adverse impact on foreign investment in the U.S. and interference with foreign commerce should be stopped before it gets worse.

3. Treaty provision is appropriate despite possible legislation

State representatives and spokesmen for the Multi-State Tax Commission urge that federal legislation is the appropriate way to address this question and that the Treaty mechanism, involving as it does a consideration only by the Senate, leaving the House of Representatives out of the process, is undesirable and inappropriate, even if admittedly proper. Preliminarily, it should be noted that despite efforts to obtain federal legislation to provide uniform standards for state taxation of income derived from activities in interstate commerce, no such legislation has emerged, principally because the states themselves could not agree upon the standards to use and hence persuaded Congress not to enact it. It is inconceivable, therefore, to imagine that the states could agree to the terms of federal legislation that would direct the computation of a state's tax base to the extent it is dependent upon operations conducted in foreign countries. The effect of the states' arguments against Article 9(4), therefore, is but another way simply to disarm the federal government from any effective activity in this area. If an "end run" is seen to exist in connection with these activities, the end run is more an end run by the states to prevent Article 9(4) from becoming effective than an end run the other way around, as asserted by spokesmen for the states.

As stated in my oral comments on July 20, and on page 26 of my written state-

ment, federal legislation would not be inappropriate. Assuming it can be enacted despite the road blocks mentioned above, it still would be necessary, as I said July 20, to have bilateral tax treaties dealing with the same subject on a country-by-country basis. Otherwise, our trading partners could not be reciprocally bound by the Article 9(4) principles, nor could they be assured that the federal statute would not be unilaterally changed to their detriment sometime in the future. The treaty mechanism is the only way to achieve both the reciprocal obligation and the certainty of continuing the provisions on a mutual bilateral basis. Thus, both a federal statute and a treaty provision could exist side by side, but in any case we must have a treaty provision.

Given the present demonstrated need and propriety of the provisions of Article 9(4), it would seem wholly inappropriate to defer adoption of the Treaty pending the unlikely possibility of enacting a federal statute. Given the readiness of the Treaty for ratification, it seems most appropriate to proceed with the Treaty without awaiting a federal statute. Legislation can come in due time.

It would appear, incidentally, that the cognizant committee of the House to handle legislation embodying the principles of Article 9(4) is the Committee on the Judiciary, not the Committee on Ways and Means, as Chairman Al Ullman's letter asserted to be the case. At least it was the Committee on the Judiciary which considered prior legislation dealing with the uniformity of state taxation of multi-state income. It is not fitting that I address the subject of committee jurisdiction and I hasten to disconnect myself from that process. I merely note the historical fact that the prior legislative effort in this area was handled through the Committee on the Judiciary, presumably because the subject matter involved only state taxes and had no bearing upon the terms of enforcement of the federal revenue laws nor upon the amount of federal tax revenue. I note with interest, however, Senator Javits' inquiry concerning the Ullman letter which urged reservation of Article 9(4) from the UK Treaty because the subject was appropriate tax legislation which his Ways and Means Committee should consider. Senator Church's answer to Senator Javits' question made clear that Al Ullman was not expressing the view of the Ways and Means Committee, but was speaking only for himself as a congressman—a congressman from Oregon, one of the three states that is applying the unitary tax system to foreign operations and which would be directly affected by Article 9(4).

4. Relative merits of unitary versus separate accounting methods

The written statements and oral testimony at the hearing are replete with data which shows that application of the unitary system to foreign operations is distortive. While the state tax authorities might agree that such is the case, they, nevertheless, seem unwilling to use the arm's length separate accounting approach with respect to foreign operations. They have not fairly articulated the reasons why they are unwilling, except to reiterate that income of a unitary business is fairly apportioned to the state on the basis of the unitary formula and that the apportioning process should take into account the operations abroad. The issue is whether the distortions should be tolerated with only such modification as the states' tax administrators may choose to apply in the exercise of their discretion, or whether it should be rejected in favor of the arm's length separate accounting method, which, with respect to those identical foreign operations, already are the subject of close scrutiny by the federal tax authorities. The federal audit information is fully available to the states and despite examples given of slowness in reaching conclusions on this issue at the federal level, it seems by far the lesser of the two evils to use internationally accepted method of arm's length separate accounting. It should be noted, incidentally, that the California statutes expressly contemplate use of an arm's length approach in appropriate circumstances. Secs. 25103 and 25137, Revenue & Taxation Code, copy in Exhibit A.

It is in the national interest to spare our trading partners the jeopardy of double taxation and interference with their foreign operations by assuring them that the various states will not be able, through their unitary system, to impact upon them on a more severe basis than does the federal government itself in the administration of its tax laws and bilateral treaty provisions.

CONCLUSION

As the written and oral statements to the Committee have emphasized, if Article 9(4) is reserved from the Treaty, the future of the entire Treaty is in

doubt. Article 9(4) is of great importance to the UK, and without it, no one can predict what a renegotiated treaty will contain. Certainly it should not be assumed, as some states rights advocates apparently do, that the United Kingdom would accept, as a substitute for Article 9(4), even the most positively expressed assurances by the California tax administrators, or even explicit state legislation, that the unitary tax would not be applied to foreign operations of a United Kingdom enterprise, assuming, of course, that the administrators would be willing to give such assurances in the first place, or that such a statute would be enacted. To be an equivalent to Article 9(4), all fifty states would have to give such assurances or enact such a statute. That is such a highly unlikely development that it should hardly even be mentioned, let alone assumed to be a practical possibility.

In order not to delay, or indeed to jeopardize, and possibly loose, the benefit of many of the desirable provisions in the new treaty, provisions which have been the subject of protracted and difficult negotiations, Article 9(4) must be retained in the Treaty.

To facilitate your handling of this supplemental material, I am sending copies to each of the other members of the Committee on Foreign Relations, and to the staff of the sub-committee on Foreign Economic Policy.

Thank you for considering these further comments.

Very truly yours,

CHARLES M. WALKER.

Enclosure.

CALIFORNIA REVENUE AND TAXATION CODE

§ 25102. Persons owned or controlled by same interests; combined report; combination or allocation of income and deductions

In the case of two or more persons, as defined in Section 19 of this code, owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may permit or require the filing of a combined report and such other information as it deems necessary and is authorized to impose the tax due under this part as though the combined entire net income was that of one person, or to distribute, apportion, or allocate the gross income or deductions between or among such persons, if it determines that such consolidation, distribution, apportionment, or allocation is necessary in order to reflect the proper income of any such persons.

§ 25103. Corporations serving or selling to stockholders or members at less than fair price; report; income allocable to state; computation

In the case of a corporation doing business within the meaning of this part, whether under agreement or otherwise, in such manner as either directly or indirectly to benefit the members or stockholders of the corporation, or any of them, or any person or persons, directly or indirectly interested in such business, by rendering services of any nature whatsoever, or acquiring or disposing of its products or the goods or commodities in which it deals, at less than a fair price therefore, the Franchise Tax Board, in order to prevent evasion of taxes or clearly to reflect the income of such corporation, may require a report of such facts as it deems necessary, and may determine the amount which shall be deemed to be the entire net income allocable to this State of the business of such corporation for the calendar or fiscal year, and compute the tax upon such net income. In determining the entire net income the Franchise Tax Board shall have regard to the fair profits which, but for any agreement, arrangement, or understanding, might be or could have been obtained from dealing in such products, goods or commodities.

§ 25104. Consolidated report of parent and subsidiary corporations; assessment of tax

In the case of a corporation liable to report under this part owning or controlling, either directly or indirectly, another corporation, or other corporations, and in the case of a corporation liable to report under this part and owned or controlled, either directly or indirectly, by another corporation, the Franchise Tax Board may require a consolidated report showing the combined net income or such other facts as it deems necessary. The Franchise Tax Board is authorized and empowered, in such manner as it may determine, to assess the tax against either of the corporations whose net income is involved in the report upon the

basis of the combined entire net income and such other information as it may possess, or it may adjust the tax in such other manner as it shall determine to be equitable if it determines it to be necessary in order to prevent evasion of taxes or to clearly reflect the net income earned by said corporation or corporations from business done in this State.

§ 25137. Apportionment by franchise tax board

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting;

(b) The exclusion of any one or more of the factors;

(c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Senator CHURCH. Thank you very much.

Our next witness is Mr. Gotelli, who will appear on behalf of the California Council for International Trade.

STATEMENT OF ANDREW W. GOTELLI, PEAT, MARWICK, MITCHELL & COMPANY, ON BEHALF OF CALIFORNIA COUNCIL FOR INTERNATIONAL TRADE, SAN FRANCISCO, CALIF.

Mr. GOTELLI. Mr. Chairman and members of the committee, I am a partner in the international accounting firm of Peat, Marwick, Mitchell & Co. and a member of the California Council for International Trade. I appear on behalf of the California Council for International Trade, CCIT, a private association of some 500 California businessmen involved in all facets of international trade. A list of organizations affiliated with the Council through corporate and individual memberships is attached.

[The information referred to follows:]

CORPORATIONS REPRESENTED ON THE CALIFORNIA COUNCIL FOR INTERNATIONAL TRADE THROUGH CORPORATE AND INDIVIDUAL MEMBERSHIPS

American Asian Bank
American-Euro Interfund Corp.
Arthur Andersen & Co.
The Asia Letter
Atkins Kroll & Co., Ltd.
Balfour Guthrie & Co., Ltd.
Banco Di Roma
Bank of America, NT & SA
Bank of Montreal (California)
The Bank of Nova Scotia
Bank of the Orient
Banque Nationale De Paris
Barclays Bank of California
Basic American Food Co.
British-American Chamber of Commerce
Business International
Calagrex, Inc.
California Almond Growers Exchange
California Canadian Bank
California Canners & Growers
California Farm Bureau Federation
California First Bank
California Pacific Associates

California Valley Exports
California International Trade Corp.
A. L. Castle, Inc.
Castle & Cooke, Inc.
Center for World Business
The Chartered Bank of London
Chemical Bank International of San Francisco
S. Christian of Cophenhagen
Citibank International
Connell Bros. Co., Ltd.
Cost Plus, Inc.
Crocker National Bank
DCI International
Ditto Freight Lines, Inc.
Dresdner Bank AG
The East Asiatic Co., Inc.
Elizalde & Co., Ltd.
Elliott Manufacturing Co., Inc.
Envirotech Corp.
Ernst & Ernst
Fairmont Hotel
Farrell Lines, Inc.
Fibreboard Corp.
First Chicago International
FMC Export Corp.
FMC International AG
Foreign Credit Insurance Co.
Forry, Golbert & Singer
L. B. Foster Co.
Fox & Carskadon
L. J. Frank Corp.
Fromm & Sichel, Inc.
Furness Interocean Corp.
Gambles Import Corp.
Glad, Tuttle & White
Golden Gate University
Graham & James
Grieco Food Co.
Hamrich International
Hawaii Pacific International
Heller, Ehrman, White & McAuliffe
Hewlett-Packard Co.
Hills Bros. Coffee, Inc.
B. J. Holmes Sales Co.
The Hong Kong Bank of California
Indonesia International, Inc.
International Harvester Co.
International Public Relations Co., Ltd.
Interport, Ltd.
Ishikawajima-Harima Heavy Industry Co., Ltd.
Jac Global International Sales Corp.
Japan Air Lines
Japan Trade Center (Jetro)
Justfrank Co.
Kaiser Engineers
Kaiser International Shipping Corp.
Kearns International
Albert Kessler Co.
Keystone Seed Co.
Kikkoman International, Inc.
David Koetser Co., Inc.
Korea Trade Center
B. M. Lawrence Co.
Levi Strauss International
Lillick, McHose & Charles

Lloyds Bank
J. E. Lowden & Co.
Maersk Line
Malaysian Trade Commission
Mark Hopkins Hotel
Mason-McDuffie Co.
Mayfair Packing Co.
Mentor International
Mitsubishi Bank of California
Mitsubishi International Corp.
Mitsui & Co. (U.S.A.) Inc.
MJB Co.
Morgan Guaranty International Bank
Nakata, Nakamura Co.
National Westminster Bank, Ltd.
Nichimen Co., Inc.
Nissho-Iwai American Corp.
North American Maritime Agencies
John Norton International
Norton, Lilly & Co., Inc.
Orrick, Herrington, Rowley & Sutcliffe
Overseas Shipping Co.
Pacific Australia Line
Pamco, Inc.
Philippine Commercial Products
Peat, Marwick, Mitchell & Co.
Peerlite Manufacturing & Supply Co.
Peloian Packing Co., Inc.
Primark Corp.
Port of Los Angeles
Port of Oakland
Port of Sacramento
Port of San Francisco
Price Waterhouse & Co.
Emmet Purcell & Associates
PVO International, Inc.
RDM Corp.
Reliance Sheet & Strip Co.
B. T. Rocco, Jr. and Co.
Rolm Corp.
Roth Properties
Royal Bank of Canada
The Royal Bank of Scotland
Royal Viking Line
Sanwa Bank of California
Security Pacific National Bank
H. Shenson, Inc.
Soule Steel Co.
Standard Oil Co. of California
Sumitomo Bank of California
Suni Candles
Systan, Inc.
Taisho Marine and Fire Insurance Co., Ltd.
Tecon Services, Inc.
Terra Marine Shipping Co.
Toronto Dominion Bank of California
Toshiba International Corp.
Toshoku, Ltd.
Toyomenka (America) Inc.
Transpacific Transportation Co.
United California Bank
Charles Von Loewenfeldt, Inc.
Washington Fish & Oyster Co. of California
Wells Fargo Bank
Westhansa Marketing Co.
Erland Wolff Consulting Services
Arthur Young & Co.

While CCIT believes that the United States-United Kingdom tax treaty as negotiated will help enhance international trade with the United Kingdom, we want to address specifically Article 9(4).

UNITARY ASSESSMENT AS DETERRENT TO INTERNATIONAL TRADE AND INVESTMENT

CCIT has long contended that indiscriminate application of the "unitary" method of taxation by the California Franchise Tax Board, specifically as applied to the California subsidiary of a foreign corporation, is a major deterrent to investment and the development of international trade in California. To discuss this issue, the board of directors of CCIT recently met in Sacramento with members of the current California administration and Legislature. While administration representatives on that occasion acknowledged the inequities of the present system, it is understandable that the administration and members of the California Legislature might find themselves reluctant to modify the system so long as they weigh its merits in terms of short term revenue factors alone.

CCIT believes the anticipated loss of revenue to the State in the specific area of foreign parented subsidiaries may be more illusory than real. We estimate it at no more than $20 million, and more likely $12 to $15 million. We also wish to point out that many of these dollars have yet to be collected, since these cases currently are being contested. But we are convinced the revenue loss could in no event be greater than the cost of jeopardizing California's stature as a center for world trade and finance, or the Nation's global economic and political ties, all of which can be expected to suffer if the current practice of unitary assessment in California continues without modification.

We do know that foreign firms which have considered establishing operations in California have in many cases been reluctant to do so, and in some cases already have decided not to do so, in large part because of the unitary tax issue. For the same reason, other foreign firms which did have operations in California have relocated to other States, and others have threatened to do so. Even California based corporations of long standing have diverted activities outside the State solely because of unitary tax considerations. This latter problem was pointed out in a recent letter to California's Governor Brown from Mr. W. E. Leonhard, president of the Ralph M. Parsons Co. Mr. Leonhard estimates an exodus from the State of an annual payroll of at least $100 million as a direct result of the unitary method of taxation as applied to California engineering firms alone. We cite this solely as an example of how relatively insignificant revenue losses would be more than compensated by removal of this major impediment to California's trade and investment, and of how employment and production would certainly expand.

CONVENTION, INCLUSIVE OF ARTICLE 9(4), ENDORSED

CCIT regrets that the solution to the California unitary reporting problem must lie in a "back door" approach, such as article 9(4) of

the tax convention with the United Kingdom. But because the California Franchise Tax Board has been reluctant to provide a remedy, the Council wholeheartedly endorses your ratification of the tax convention, inclusive of article 9(4).

California is indisputably the Nation's gateway to the Pacific Basin. While adoption of the instant tax convention with the United Kingdom might not directly affect our lucrative business with the Pacific, we believe a number of legal considerations would have a salutary result, upon adoption of the treaty, of prohibiting imposition of the unitary method of combined reporting upon California subsidiaries of companies domiciled in all foreign nations. To be sure, investment in California by United Kingdom enterprise is not inconsequential.

The various purposes underlying negotiations of the treaty with the United Kingdom regrettably be thwarted should article 9(4) not be included in the ratified version of the treaty. That the interests of the United States in the area of international relations may outweigh local tax considerations is recognized in the various consular treaties entered into by the United States. Such treaties typically provide that alien employees of foreign consulates in the United States shall be exempt from Federal, State and local taxation of their consular compensation. Also in *Scandinavian Airline System* v. *Los Angeles*, 42 Cal. 2d 11 (1961) the California Supreme Court held that Los Angeles County was prevented by the United States-Sweden tax treaty from levying a property tax on aircraft owned by the Swedish Airline. Many other examples exist as to Federal intervention in the interest of consistency, equity, and national interest. Under its constitutional authority to regulate commerce with foreign nations and among the States, Congress, for example, has limited the jurisdiction of States to tax income derived from interstate commerce (Public Law 86–272, 1959), has prohibited extension of State tax laws to the Outer Continental Shelf (Public Law 83–212, 1953), and enacted in 1973 the State Taxation of Depositories Act (Public Law 93–100, Sec. 7).

INEQUITIES IN UNITARY METHOD OF TAXATION

CCIT is aware of the theoretical arguments that can be put forth in defense of the unitary method of taxation. We will grant that efficient collection and administration of taxes of multinational corporations might be facilitated if all taxing authorities throughout the world were to employ an identical unitary method of taxation. We believe, however, that debate on this matter is best left to academicians. We must deal with the real world of international trade and business. The fact is that California is unique among States and unique in the world in aggressively enforcing the concept of combining both domestic and foreign corporations for the unitary method of taxation. California is not going to change the taxation practices of the rest of the world.

Where one taxing authority uses the unitary method and all other taxing authorities use the wisely accepted method of separate accounting subject to "arm's length" rules on inter-company pricing and charges, inequity can and often does result. One example of a gross inequity will be presented to the committee in the testimony of William D. McKee, Esq.

This Council believes that California would do well to assess its taxpayers by a method which is consistent and uniform with the systems used by other States, the United States, and other major free world trading nations.

Foreign parent corporations view the requirement that their worldwide operations be subject to review by the California Franchise Tax Board as violative of basic concepts of international business and of their privacy since they are not directly subject to the jurisdiction of the State of California; they view the necessity of converting foreign books and records to California's tax accounting principles as an immense, unnecessary and costly record keeping burden; they view the fact that the Franchise Tax Board has not issued guidelines in needed areas such as the conversion of foreign currency into U.S. dollars, as one manifestation of the arbitrary administration of the unitary tax method.

RATIFICATION OF ENTIRE CONVENTION URGED

As members of the Foreign Relations Committee, you are abundantly aware of the importance of international business to the economy of the United States and the world, and you know the important contribution which tax conventions make to the encouragement and facilitation of this business.

The CCIT firmly believes that encouragement of such business in the Nation's largest State is vital to the economic interests of the Nation as a whole. It is also vital to the continuation of friendly relations between the United States and its overseas business partners and allies, many of which are deeply ensconced in the California market. Article 9(4) constitutes a key step in furtherance of those interests; we respectfully urge your ratification of the entire convention.

I appreciate the opportunity to make this presentation.

Senator CHURCH. Thank you, Mr. Gotelli.

Our next panelist is Carl Stutsman appearing on behalf of the Los Angeles Area Chamber of Commerce.

STATEMENT OF CARL A. STUTSMAN, JR., ON BEHALF OF LOS ANGELES AREA CHAMBER OF COMMERCE

Mr. STUTSMAN. Thank you, Mr. Chairman.

While I am a tax attorney, also practicing in Los Angeles and got my training with the Internal Revenue Service, my interest here is as a representative of the Los Angeles Area Chamber of Commerce. I have no clients yet enmeshed with the Franchise Tax Board and had none, so I am speaking primarily because of our interest in what this system has done to the economy of the State of California. I think to understand the problem it is helpful to look back on the system of taxation with which we live.

EFFECTS OF CALIFORNIA TAXATION SYSTEM

You gentlemen deal with the theories of the law. You draft the laws and present them to us to work with. We as tax practitioners deal with the practicality of those tax laws and it is those practicali-

ties, as they exist in the State of California that have brought us to what must be conceded to be a rather extraordinary situation where a major friendly nation has sought treaty restrictions on a system which has become so unfair and so burdensome in its administration.

This is not a statutory system, Mr. Chairman, with which we deal. It is an administrative burden created by the Franchise Tax Board in its own regulations and its own administration of those regulations.

The question has been asked where does our Governor stand on this issue? His latest pronouncement appears to be that the system may not be quite as good as he first felt, but that it should continue to be applied at least to the oil industry and in Canada and in Mexico. Now, whether that is an accurate quotation or not I do not know but it is indicative of the problem with which this treaty deals.

It is the administration of the system and not the system itself that creates our difficulty. California has a section in its Revenue and Taxation Code, 17615, which is a verbatim transportation of section 482 of the Internal Revenue Code. We have lived with that system in California. It has been administered effectively for a great number of years and it is idle to imply that somehow or other California does not have the sophistication to live with that system if the last four years of usage of the unitary formula on a worldwide basis should be prohibited by the enactment of this treaty as we respectfully urge this committee to recommend.

The voluntary compliance system in California is a very different thing, Mr. Chairman, from the Federal. We do not have the remedies available to our taxpayers that are available at the Federal level. The administration of the law can be an extreme burden in our State where the taxpayers have few protections, tax court petitions, for example, as at the Federal level. I will not repeat the material in my written presentation relative to the economic impact of this unitary system as it has evolved in the last 4 years because that would be wasting the committee's time and duplicating the material presented by others. But I would like to urge the committee to realize that the application of this formula has seriously affected the economy of our State. A number of foreign companies have indicated their unwillingness to subject themselves to California taxation.

Governor Brown, in his visit to Japan came back almost completely persuaded that the system that he recommended when he wrote to Senator Sparkman was not the system as it in fact actually does exist. He has, as a good leader of the State, substantially modified his position as a result of his own personal visit to Japan in seeking new industry for the State of California.

Another aspect of this system which is little noted but extremely important, Mr. Chairman, is the number of cases where a California company, I am thinking of TRW as one illustration, although they are successful in obtaining contracts with foreign businesses, have specifically requested that those contracts be performed in out-of-State branches so that foreign supervisory personnel will not be subjecting the contracting party to the California taxing authority. So we are losing substantial businesses in the State so far as our own employment situation is concerned, even though our companies may be successful contracting parties.

CLAIM OF "END RUN" AROUND HOUSE

We have been subjected in these hearings to what I consider to be a diversionary tactic that somehow this procedure is an "end run" around the second House of Congress. In other words, if this is a tax matter it should be originated in the House of Representatives and not in the U.S. Senate. On that, I submit, Mr. Chairman, on analysis of the situation the claim simply does not stand careful examination.

The House Ways and Means Committee and the House of Representatives is not constituted to act as an arbitrator between 1 State, 10 States, or 50 States and 1 foreign nation or a number of foreign nations. That is what we deal with in this situation. It is not a tax policy so much as it is the results of a tax policy with which we are dealing. To say that this procedure of resorting to the treaty negotiations processes as the British did constitutes somehow or other a derrogation of our system of two Houses of Congress simply will not wash on analysis. To say that the House of Representatives should participate in this type of problem is simply to distort what in fact the problem really is.

SERIOUSNESS OF PROBLEM WITH WHICH U.K. TREATY DEALS

May I close these remarks, Mr. Chairman, by repeating that the mere fact we deal with such an extraordinary situation of a friendly foreign nation of important significance seeking protection against the conduct of one State, with two others joining in, and some illusory number potentially in the wings, is evidence of the seriousness of the problem with which this treaty deals. I submit, Mr. Chairman, that the thing that this commitee can do to represent the State of California most effectively is to reject these arguments that the treaty somehow or other is unfair to the State and to realize that the economic benefits that will result far outweigh any supposed losses of revenue and I suggest that the losses as estimated are far from being supported by any factual information.

Thank you very much, Mr. Chairman.

[Mr. Stutsman's prepared statement follows:]

PREPARED STATEMENT OF CARL A. STUTSMAN, JR., ESQ.

Mr. Chairman and members of the committee: I am an attorney at law practicing in Los Angeles, specializing in tax work since 1946. I am not representing any client in this requested appearance, nor am I currently representing any clients who would be affected by Article 9(4) of the Treaty [or who are currently being taxed under the unitary formula on offshore income].

I am appearing here solely because I believe the taxing practices which this Treaty will correct have been a serious detriment to the economic health of the State of California, and thus indirectly, to the economic health of the United States.

California was one of the earliest states to adopt the so-called Unitary Formula tax concept; the first to ignore the separate corporate entities when it suited their purposes to do so; and, the first to extend the unitary concept to a world-wide usage. The basic assumption is that each component part of a company organization contributes its proportionate share to the whole of that company's profits. Thus, each part should be entitled to receive the tax due on its "share" of the "net profits" realized from a world-wide basis. This concept has a delusive attractiveness to an impartial observer. Applied on a nationwide basis, it can be and generally is reasonably fair in its application and

operation. About four years ago, however, the State of California decided that it should begin expanding the concept and applying it on a world-wide basis. This application caused the distortions which have resulted in the extraordinary situation of the federal authorities being asked to put a stop to what has evolved in an internationally-negotiated treaty.

Like every other formula, its operation depends to a large extent on the people who apply it. Subjective factors can and frequently do completely override clear rules and operating policies.

When the Unitary concept was expanded to cover international operations and applied as rigidly as it has been by the State of California, a complete new and staggering set of problems was created.

First, accounting concepts differ from one country to another and must be reconciled to the satisfaction of the California authorities. Generally, an impossible task.

Second, the impact of wages on the overall profits differs widely from one country to another, and the amount of wages paid differs equally widely.

Third, overhead cost cannot be fairly compared from one country to another.

Fourth, the value of capital in the total equation differs from one country to another.

Fifth, impossible burdens of proof arise which cannot be met by any reasonable effort on the part of multinational corporations.

Sixth, the impact of the monetary rate-of-exchange variations the world-around is completely distorted in the application of the formula by the State of California.

Finally, incredible problems would ensue if every State in the Union applied the same concept as does California. Of course, they have an equal right to do so.

The Unitary formula has seriously damaged the present economy of California in two important respects:

(1) Foreign companies, either presently located in California or contemplating locating in California are now seriously questioning whether they should continue to do so or change their plans in view of the problem created by the application of the Unitary formula.

(2) In certain important instances, California companies who are contracting with foreign customers have been requested to perform the contract in non-California branches, in order not to expose the foreign company to the California taxing authorities through the presence in California of their supervisory personnel.

As you gentlemen well know, ratification of this Treaty with its restrictions on the State of California under clause 9(4) is fully supported by the United States Treasury. The opposition of the State of California is based on substantially overstated estimates of its impact on California tax revenues. The charges of the economic results of such a Treaty are unsupported exercises in "figure assembling." This fact was all but admitted by two of the important Franchise Tax Board officials in a meeting held in San Francisco, California on February 17, 1976.

The fact that the United States has been asked by a major and responsible foreign nation to execute a Treaty such as this, under our dual system of government, is eloquent testimony to the seriousness of the problem which Section 9(4) will correct. Furthermore, section 7(2) provides for application of a taxing concept consistently used by the United States Government, and also available to the State of California under section 17615 of its Revenue and Taxation Code, for restructuring any business transaction which is not handled on an arms-length basis. The Federal Government has long been able to live with this provision, not only in domestic but also in foreign taxation. The protection it affords is completely adequate to the State of California.

Commitments made by the United States Government to other countries such as those evidenced by the negotiated Treaty should not be undermined by th complaint of any particular State. If the Foreign Relations Committee accepts the objections of the State of California, such a result would clearly follow.

Rightly or wrongly, concern with the approach used by the Franchise Tax Board (and eloquently demonstrated by its presentations in connection with this Treaty) has hung heavily over the economic growth of the State of California and thus, of the United States. It is my concern for these problems, as a citizen and as a practicing lawyer in Los Angeles, that has caused me to

seek your indulgence by this appearance. The Treaty will reverse this trend and I strongly urge its ratification as it was negotiated.

May I express my personal thanks for your affording me this opportunity to appear. I will be more than happy to answer questions which anyone might wish to present.

Senator CHURCH. Thank you very much, Mr. Stutsman.

QUESTION BEFORE COMMITTEE

Several of you have mentioned how this treaty would serve the interest of California or solve the problems that California now faces. This misses the point. It is not the responsibility of this committee to solve California's problems. The question before us is whether or not the treaty serves the interest of the United States, whether or not it unduly interferes with the prerogatives of the Governments of the various States in matters of tax policy. If the unitary tax is in fact discouraging investment in California, I should think that the California State Legislature would be inclined to appeal it.

That argument is forceful and it has been presented to me this morning that I should think the proper forum would be the State legislature.

In any case, I don't think this committee can dwell with the merits or demerits of the unitary tax as such. I think the question before us is whether this treaty advances foreign policy interest of the United States, whether it transgresses too far the prerogatives of the State government. Those are questions we have to decide. Whether or not the unitary tax service serves the best interests of California is a matter again that California has to decide.

Mr. STUTSMAN. May I respond briefly to that, Mr. Chairman.

I simply did not want inferences left from what I said that California's problems are divorced from those of the United States. We are simply one of the 50 States. Its the problems of this country that are being solved, not simply our own, Mr. Chairman.

Senator CHURCH. We are getting into philosophical question of unitary, what the Federal system means and what the prerogative of the State should be. We have three more witnesses. One more on this panel, Paul Berger, who is here on behalf of the Screen Actors Guild.

STATEMENT OF PAUL BERGER, ON BEHALF OF THE SCREEN ACTORS GUILD

Mr. BERGER. Thank you, Mr. Chairman. As you said, my name is Paul Berger. I am an attorney and principal in the firm of Berger, Berger Kahn and Shafton, a professional corporation of Los Angeles, Calif. It seems to be California day here.

Senator CHURCH. And you are all lawyers.

Mr. BERGER. Our firm is general counsel to Screen Actors Guild, a labor organization containing 36,000 professional employees in the motion picture industry. I speak for these people and I also understand that my statement today is being supported by the council of AFL–CIO unions for professional employees. Further, I speak as an American for professional and professionalism in general.

DISCRIMINATION UNDER ARTICLE 17 OF U.K. TREATY

We heard a lot this morning about discrimination and multinational corporations and unitary taxes and other tax problems. I appear here today because of a simpler problem. Namely that the proposed tax treaty now under examination by this committee contains a provision, namely, article 17, which arbitrarily discriminates against certain occupations and persons and specifically actor members of Screen Actors Guild.

As might be expected from what I have just said, the guild opposes these treaties as they are presently written—not because the Guild takes any position pro or con on the manifestly laudable objectives of the treaties—but because the objectives of the treaties are specifically denied to a small number of Americans who have achieved professional recognition.

The stated purpose of the treaties is to "avoid double taxation and to prevent fiscal evasion".

EFFECT OF HIGHER BRITISH INCOME TAX

These are laudable goals—and a legitimate subject for international agreement. Surely it is simple American fairness which compels us to agree that no one should be subject to double taxation. If I went to London to perform legal services and stayed there several weeks and returned home to America, it would be patently unfair for me to be taxed on the income I earned in Britain, only to be taxed by the United States again.

Of course, I understand that under our law as it stands today, I would be granted a credit against my Federal Income Tax by reason of having paid income tax to Great Britain. But the credit would not right the wrong done to me. British income taxes are higher than ours. The amount of tax I would pay in Britain with a given amount of income would be higher than the amount I would have to pay here, yet it is only the U.S. tax that I would otherwise have paid on that income that I may credit. So, if I earned X number of dollars in Briain and the British tax was $30,000 on those dollars and the U.S. tax $20,000, I would be allowed a credit against my U.S. tax of only $20,000. The extra $10,000 I paid to the British taxing authorities would simply be the penalty I would have to pay in order to earn income in Great Britain.

Remember, it is not the same for an Englishman earning money here. Since Great Britain's tax rates are higher than ours, the Englishman would be entitled to full credit against his Great Britain tax for taxes paid while he was in the USA. Thus, there would be a tax disincentive, or penalty—for the American contemplating foreign employment in Britain, but no effect at all upon the Englishman coming here.

The treaties deal with this problem in a straightforward manner. Provided the income earner is resident in the foreign country for less than a stipulated period of time, income earned abroad is exempt from tax by the country where it is earned. So, if I performed legal services in London and stayed less than 183 days, under the proposed treaty, I would incur no liability for British income tax.

EXCEPTION OF ACTORS, MUSICIANS AND ATHLETES QUESTIONED

The treaty, then, will successfully protect any American who journeys to Great Britain from double taxation on income earned while working in England for short periods of time, unless the American is an actor—or a musician—or an athlete. Why, I ask, should the treaty not apply to all Americans equally? Why should actors be subject to double taxation and not salesmen, professors, engineers, pilots, deepsea divers or U.S. Senators? Is it to discourage cultural exchange? If so, why exempt painters, sculptors, writers, composers, architects and scholars?

I want to give you another example to demonstrate the point—again using the British treaty:

Suppose Colossal Studios decided to make a film biography of the life of Winston Churchill and to film it on location in England. Being a major project, one or more of the top executives of the studio might travel to Britain to obtain rights to close the Churchill deal. He would be followed by other studio personnel, including location scouts, producers, directors, business managers, researchers, writers, publicists, art directors, set directors, agents, personal managers, composers, cameramen, lighting and sound men, actors and others.

In short, perhaps dozens of Americans would earn money abroad in connection with the making of this epic motion picture. All of these Americans would earn money for their efforts—in many cases more than the actors—and all of these Americans would be exempt under the treaty from British tax on their income. All, that is, but the actors.

Is it the activity—acting—which must be singled out for discriminatory treatment? Or is it a special sub-class of Americans—actors—which is not worthy of the protections afforded everyone else?

Senator CHURCH. Who besides actors?

Mr. BERGER. Musicians and athletes.

Senator CHURCH. Do you suppose that exception is because of the large amounts of money that are commonly earned by these people?

Mr. BERGER. I understand the source of that is that the Treasury feels that people like the Beatles make loads without lifting a shovel and America ought to get some of the revenue. Unfortunately in pursuing that objective there is a discriminatory provision in the treaty against American actors and American musicians and athletes who are professionals. As a further example, if a publicist gets paid for publicising the film on British television his earnings would be exempt. If the star of the film went to London and appeared on the same television show his earnings would not be exempt. They might have appeared on the same show or worn the same clothes, said the same thing about the film in the same way and been paid in the same amount for publicising the film. Why should the publicist's earnings be exempt and the actor's not? We think the answer under the treaty is an unsatisfactory one particularly to any American who believes in equal justice under the law.

The answer under the treaty is that "you are an actor".

SCREEN ACTORS GUILD POSITION

We came to Washington to tell you that actors are as good as everyone else. They work and they vote, they raise families, they pay

taxes, they campaign for Congressmen. In times of national emergency they have given freely of their time and talent. They are good citizens. They are entitled to be free from discrimination at the hands of their own Government. The justification as I said made by the Treasury is that they should not permit foreign entertainers from earning substantial amounts of money and taking it home without taxes.

Our position is that if this is the policy then apply it equally. The interesting thing is that even the dollar limitations in the treaty are discriminatory because some actors are exempt under $15,000 and others are not. There are no dollar limitations imposed on any other class or occupation. A salesman for IBM might make a sale in Great Britain. His commission might be $500 or $500,000. No matter, because he is a salesman, not an actor. If the dollar limitation is the deciding factor in determining which part of the class is to be discriminated against we feel another disturbing point is raised.

That is, the treaties institutionalize a system which punishes or minimizes or equalizes—phrase it any way you want—financial success. The treaties contribute to the disturbing movement abroad and in this country to abandon the ideal of "equal opportunity" in favor of "equal result". Thus the person who is talented, or successful, and who through his energies sticks his head above the crowd, must be punished. His achievement must be leveled off—like shears passing through the top of a shaggy hedge. Mediocrity must be enforced.

Voltaire once said:

> Equality is at once the most natural and most chimerical thing in the world; natural when it is limited to rights—unnatural when it attempts to level goods and powers.

Actors and other performers are by the nature of their occupation highly visible. They play to audiences. They attract publicity. If they become popular, they are successful and with that success comes financial reward which, I also recall, is the keystone of our American system.

If we are going to live by the credo that success ought to be penalized, then it is unfair to penalize only actors. If Charlie Smith sells two 747's to British Airways and earns a huge commission, who knows about it? Under the treaty, he is protected. But if Paul Newman signs a $1 million contract, it will be reported on the 6 o'clock news all over the country, and he won't be protected by the treaties.

These provisions discriminate unfairly against actors because actors are singled out for unequal treatment as a class. This is a clear violation of the principle of equal protection under the law, afforded every American under the 14th and 5th amendments to the U.S. Constitution.

Senator Javits earlier was commenting on discrimination against the rich or middle class. His comments are appropriate here.

I would like to know whether the Treasury has requested or obtained an opinion of the Attorney General of the United States evaluating the constitutionality of these provisions, because it is our professional opinion that, if enacted, in the absence of some extraordinary justification for the singling out of actors as a class for discriminatory treatment, these provisions will not withstand constitutional scrutiny.

Like the wag who wrote "Not For Pigeons" on the edge of the reflecting pond in front of the Washington Monument, our Government would write "not for actors" in its international treaties.

This kind of discrimination should not be tolerated by a people dedicated to, and openly advocating and exporting abroad, the principle of equal opportunity.

Thank you for your time.

[Mr. Berger's prepared statement follows:]

PREPARED STATEMENT OF PAUL S. BERGER, GENERAL COUNSEL, SCREEN ACTORS GUILD, AFL–CIO

The purpose of the treaties before this committee is to avoid double taxation and prevent fiscal evasion.

These are laudable goals, and a legitimate subject for international agreement.

Unfortunately, however, while these treaties are generally effective in protecting the citizens of each country against the burden of double taxation, they contain certain provisions which, by discriminating against actors, musicians and athletes, make second-class citizens out of the members of the Screen Actors Guild.

Were it not for the protections generally afforded by the treaties, every American who ventured abroad to earn a part of his living would pay higher taxes on his total yearly income than his neighbor who earned the same amount during the year but stayed at home.

Under present American tax law, and Article 23 of the proposed treaty with Great Britain, the American citizen who reports earnings abroad is allowed a credit against his federal income tax by reason of having paid income tax already in Great Britain. This does not provide full protection against excessive taxation because British income taxes are higher than ours. Although the amount of tax paid in Britain on a given amount of income is higher than the amount that would have to be paid here, it is only the tax that would have been paid on the same amount of income earned in the U.S. that may be credited.

For example, if John Quincy Adams earned "X" dollers in Britain and the tax there was $30,000, and the tax here on "X" dollars was $20,000, he would be allowed a credit of only $20,000. The extra $10,000 that John paid to Inland Revenue, the British taxing authority, would be a penalty he would have to pay in order to earn income in Great Britain.

Parenthetically, it should be noted that the same result would not obtain against an Englishman who earned part of his income in the U.S. Because British taxes are higher than ours, he would receive full credit for taxes paid here against those due in England.

It is readily observed that such an arrangement does nothing to encourage the British citizen to earn income in America, and in fact discourages the American contemplating employment in Great Britain. In general, these less-than-full-credit system discourages the export of talent from a low-tax to a high-tax country.

The treaties deal with this problem in a straightforward manner. Except for the requirement that an income earner be resident in a foreign country for less than a stipulated period of time, income earned abroad is exempt from tax by the country wherein it is earned.

Article 14 of the proposed treaty with Great Britain, *Independent Personal Services*, provides that a resident of State X who derives income from the performance of personal services in State Y is taxable in State Y if:

"(a) The person is present in State Y for more than 183 days aggregate in the tax year, or

"(b) The person has a 'fixed base' in State Y for the purpose of performing personal services in State Y."

If an American lawyer spends 182 days litigating in London, and he has no "fixed base" there, he will not have to pay taxes to the Queen.

Similarly, Article 15 of the proposed treaty with Great Britain, *Dependent Personal Services*, (meaning in particular one who is an employee of a corporation) provides that income earned by a resident of State X while working in State Y is taxable in State Y unless:

"(a) The wage earner is present in State Y for not more than 183 days aggregate in the tax year, and

"(b) The wage earner is paid by an employer who is not a resident of State Y, and

"(c) The wage earner's salary is not 'borne' by a 'permanent or fixed base' that his employer has in State Y."

If a British law practice contracts with an American professional law corporation for the services of an American lawyer, who then goes to London for 182 days, the wages paid him by the American corporation relating to the rendering of these services abroad will not be taxable by the Queen.

These protections apply not only to lawyers, but to any American who earns income in connection with the performance of his personal services abroad, UNLESS HE IS AN ACTOR, MUSICIAN OR ATHLETE.

Article 17 of the proposed treaty with Great Britain, *Artistes and Athletes*, doubly provides that:

"(1) Notwithstanding Articles 14 and 15, entertainers, musicians, and athletes who are citizens of State X providing personal services in State Y, may be taxed in State Y if their income derived from personal services rendered in State Y exceeds $15,000 per tax year."

Similarly,

"(2) Income paid to a State X entertainer, musician, or athlete by a State X corporation (such as a so-called 'loan-out'; that is, a corporation created for the purpose of loaning out the services of an actor) for services rendered in State Y, may be taxed in State Y as above, regardless of the protections afforded other professionals by Article 15."

Articles 14, 15 and 17 of the British treaty are followed in the proposed treaties with Israel and Egypt, with minor differences. Note, however, that the article numbers do not correspond.

Beginning with Israel:

Aritcle 16, *Independent Personal Services*, of that treaty corresponds with Article 14 of the British, except that the time period to trigger taxation is "183 days or more," rather than "exceeding 183," giving the British/American exchange one more tax-free day. Wouldn't something more uniform make sense?

Article 17, *Dependent Personal Services*, corresponding with Article 16 of the British treaty, requires in addition to the three elements therein, that the income be taxable in the home state (State X) if it is to be exempt.

Article 18, *Public Entertainers*, corresponds with Article 17 of the British treaty, but sets a different income limit of $400.00 per day to trigger taxation in the foreign country (State Y).

The Egyptian treaty is nearly identical with the Israeli, except that:

Article 15, corresponding to British Article 14, sets a 90-day time limit; and

Article 16, corresponding to British Article 15, sets a 90-day time limit, each "less than 90 days."

This adds up to the following:

All persons traveling abroad to perform personal services for less than a stipuated period of time do not have to pay taxes on income earned abroad, other than that which they pay at home; except for actors, musicians and athletes, who are arbitrarily discriminated against as a class.

The justification made by our Treasury for including such blatant discrimination in the treaty is that people like the Beatles tend to make loads without lifting the shovel for very long, and that we ought to cut ourselves in on a pieces of the action.

If it is our policy to tax people who are able to earn relatively large incomes in a relatively short period of time, so be it. But treat such highly successful citizens equally. Do not single out easily stigmatized actors, musicians and athletes for discriminatory treatment.

Article 17 of the proposed treaty with Great Britain and the corresponding provisions of the proposed treaties with Israel and Egypt discriminate against actors, musicians and athletes as a *class*. In so doing, these articles violate the principle of equal protection of the law contained in the Fourteenth Amendment and incorporated into the Fifth Amendment to the United States Constitution by judicial decision. A superb example of just how this discrimination operates is contained in the testimony of Mr. McCalman given before this very Committee in 1948, at page 99 (attached).

Mr. McCalman states:

"If I were a salesman, a resident of the United States, employed by an American aircraft company, and I took a trip to England and was successful in selling $20 million in airplanes for my American company, on which I was paid a commission of 5 percent, and I did all this within a period of less than 183 days, and subsequently made one million dollars, I would not be liable for any United Kingdom taxes. Obviously, I would have to pay taxes to the United States.

"On the other hand, if an actor, a resident of the United States, employed by an American company, renders his services in England and makes $10,000 for ten weeks' services, he is required to pay taxes to the United Kingdom, as we read [new Article 17]. What in the world is the difference between the airplane salesman who makes a million dollars, and the actor? Neither one of them should be subject to United Kingdom taxes, and that is why we are here objecting to [new Article 17]."

Senator Lucas:

"You contend that you are being discriminated against because there are exemptions for other classes of people in the same category that you contend you are in?"

Mr. McCalman:

"That is right. All other 'residents' of the United States except actors are exempt from United Kingdom taxes where they are employed by an American employer and perform their services in England during a period of less than 183 days in any taxable year. What we cannot understand is why the discrimination against actors in [new Article 17]?"

Mr. Calman's testimony was apparently well taken. The treaty which was subsequently approved by the Senate did not contain the discriminatory provision.

When this Congress passes a law that discriminates *on its face* against one class of American citizens (as Article 17 of the proposed treaty with Great Britain would), and it is challenged in the courts, it is subjected to the strictest Constitutional scrutiny.

In such cases, if the law seeks a Constitutionally permissible end, it will be allowed to stand *only if justified by the most urgent need*, coupled with an inability to achieve that end by means that do not single out a class of Americans for discriminatory treatment.

As an example of these extraordinary circumstances, a rare case in which the United States Supreme Court *upheld* a law that discriminates *on its face* against a class of Americans is *Korematsu* v. *United States of America*, 65 S.Ct. 193, 323 U.S. 214, 89 L.Ed. 194 (1944).

In this hotly disputed case, the Supreme Court found that the fact that we we were at war with Japan, the proximity of California to the Pacific Ocean, and the impossibility of determining who was a threat to our national security combined to create an extraordinary situation in which the detention of Japanese American citizens in camps removed from the coast was justified. The justice of the *Korematu* decision is still disputed today.

Without belaboring the point, it is manifestly clear that there is no such justification for singling out actors, musicians and athletes for discriminatory treatment in these treaties. Article 17 in the proposed treaty with Great Britain and its counterparts in the proposed treaties with Israel and Egypt are unjust. They are unnecessary. They are un-American. We beseech this committee to expunge them from our international agreements.

To: The Senate Foreign Relations Committee, Senator John Sparkman, Chairman,

Enclosed herein is a copy of Exhibit "A," the testimony of Mr. Adrian McCalman, et al. before the United States Senate Subcommittee of the Committee on Foreign Relations regarding "Conventions with Great Britain and Northern Ireland Respecting Income and Estate Taxes" given on Wednesday, April 17, 1946.

The 1948 testimony is incorporated by reference at page 6 of the Written Statement of the Screen Actors Guild presently on file with the Committee.

Respectfully submitted,

PAUL S. BERGER,
General Counsel for the Screen Actors Guild.

CONVENTIONS WITH GREAT BRITAIN AND NORTHERN IRELAND RESPECTING INCOME AND ESTATE TAXES

WEDNESDAY, APRIL 17, 1946

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

The subcommittee met, pursuant to call, at 10 o'clock, in the committee room of the Committee on Foreign Relations, in the Capitol, Senator Scott W. Lucas, acting chairman, presiding.

Present: Senators Lucas (acting chairman) and La Follette.

Also present: Eldon P. King, Special Deputy Commissioner, Bureau of Internal Revenue, and Colin F. Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation.

(The subcommittee met for further hearing in connection with Conventions with Great Britain and Northern Ireland, respecting income and estate taxes, viz, Executive D, 79th Cong., 1st sess., and Executive E, 79th Cong., 1st sess.).

PROCEEDINGS

Senator LUCAS (acting chairman). The committee will be in order. Let the record show that on May 23 and June 13, 1945, this subcommittee of the Committee on Foreign Relations held hearings on two conventions with Great Britain respecting income and estate taxes. Later, that subcommittee made its report to the full committee. The full committee approved the conventions. Thereafter that report was submitted to the United States Senate for its approval. It remained upon the calendar of the Senate for some time without action. While the report was awaiting action, certain interested groups representing the Screen Actors Guild and the Artists Managers Guild and others requested that the report be resubmitted to the Committee on Foreign Relations in order that they might testify upon certain phases of the Conventions.

As I understand it, article XI of convention D is involved before the committee this morning. Article XI provides:

ARTICLE XI

(1) An individual who is a resident of the United Kingdom shall be exempt from United States tax upon compensation for personal (including professional) services performed during the taxable year within the United States if (a) he is present within the United States for a period or periods not exceeding in the aggregate 183 days during such taxable year, and (b) such services are performed for or on behalf of a person resident in the United Kingdom.

(2) An individual who is a resident of the United States shall be exempt from United Kingdom tax upon profits, emoluments, or other remuneration in respect

of personal (including professional) services performed within the United Kingdom in any year of assessment if (a) he is present within the United Kingdom for a period or periods not exceeding in the aggregate 183 days during that year, and (b) such services are performed for or on behalf of a person resident in the United States.

(3) The provisions of this Article shall not apply to the compensation, profits, emoluments or other remuneraiton of public entertainers such as stage, motion-picture, or radio artists, musicians, and athletes.

It is the understanding of the chairman of this committee that paragraph (3) of article XI is the one in controversy.

The clerk of the committee has given me the names of three witnesses who are here this morning to testify as to why that section should be deleted from the convention. Are Mr. Dales, Mr. Abel, and Mr. McCalman all here?

Mr. McCALMAN. Yes, sir.

Senator LUCAS. Which one of you gentlemen wants to testify first?

Mr. McCALMAN. Mr. Dales.

Mr. DALES. I will, Senator Lucas. And may I proceed?

Senator LUCAS. Proceed, sir.

STATEMENT BY JOHN DALES, JR., ON BEHALF OF THE SCREEN ACTORS GUILD

Mr. DALES. I am John Dales, Jr., executive secretary of the Screen Actors Guild, the American Federation of Labor union representing all motion-picture actors in the United States. In addition to Mr. Walter Abel, our president, George Murphy, was to appear, but this notice of hearing caught him in the middle of a picture assignment and in consequence he had to forego this meeting.

Actually we have very little to say. Our only reason for planning to have more persons here on our behalf was to show the sincerity of our feelings with respect to our appeal for the deletion of section (3) which you have read. On a theory so nebulous as to incline one to wonder if it was not rationalization after the fact, the Internal Revenue Department has caused to be inserted into that treaty a clause, section 3, article XI, which baldly excludes actors from the benefit of the treaty. In his message of recommendation to the President, the Secretary of State decried the severe burden of the imposition and the collection of taxes upon the same income by both the United States and the United Kingdom, and he described this treaty in his message as a solution, insofar as practical, to the severe character of double taxation.

Without more—without figures or prognostications, as actors we say to you, What is there different about our profession that we alone should continue to carry the burden that our Government proposes to lift from the backs of everyone else—doctors, lawyers, salesmen, businessmen, government representatives, and all other professions, businesses, and activities?

There was a time in England, and for that matter, in the early history of some of our States, when actors were officially noted on the statutes as "rogues" and "vagabonds." That time, we think, is no more. Actors as a class have proved their desire, worthiness, and ability to take their place in civic, community, and national affairs, and in fact in times of emergency or need are particularly called upon by their National Government, the Treasury Department, and the War

Department, to give freely of their time and talents. They have always responded, and in fact are today responding, to these pleas. They do not then understand why this Government should set them apart adversely from all other occupations.

You are aware, I am sure, that the profession of acting is not a more lucrative one than law, medicine, or literature. Out of 8,000 motion-picture players in the industry, 400 make more than $15,000 annually. Of these 400, only approximately 150 approach those sums which the public likes to associate with actors—$50,000 a year or more. The other 7,600 players make from $2,000 to $15,000 a year, with the mesne, at our best calculation, approximately $6,000. Furthermore, as to those few who reach the pinnacle of financial success, their balance is a precarious one, and in the main they do not continue in that position for many years. That is a brief economic picture of the motion-picture actor.

Of the arguments which I have heard and read of the Internal Revenue Department for this separation of actor from all others, I think only two need be given consideration. They are—

(1) Custom.

(2) The statement that actors may go into another country for a short period of time and retreat with a goodly sum of money.

As to custom, I would like to say, I understand this claim to be based upon the League of Nations Model Bilateral Convention of 1943, and upon the French, the Swedish, and the Canadian Conventions. I have read the model convention, and in my knowledge it contains no similar provision to section 3, article XI, whatsoever. There is a reference to taxing touring shows, but also a statement that competent administrations of the negotiating countries may agree on special provisions in this regard. There is no mention of actors as a class or of public entertainers as a class.

I find nothing on the subject in the French treaty whatsoever—no mention. There are similar provisions in the Swedish and Canadian Conventions. All I can say of such provisions is that they have never been brought to our attention, and I doubt that there have been a handful of instances where circumstances have caused such provisions to be put into effect. Certainly we feel that they furnish no argument of meritorious precedent, but merely of having existed unnoticed.

Senator LUCAS. May I ask you, right there?

Mr. DALES. Yes, Senator.

Senator LUCAS. The Swedish Convention has been in effect for some time, so has the Canadian Convention.

Mr. DALES. That is right.

Senator LUCAS. How does it come that you have not discovered this sort of taxing section in these previous treaties?

Mr. DALES. Senator, my best guess on that is that the interchange of acting talent between this country and Sweden, or this country and Canada, has been so slight as to never have created the issue. I am not certain—and this is guess, purely—I am not certain that the Canadians, for example, take full advantage of their right to tax. I have no way of knowing.

Senator LUCAS. I am not interested in that. I am only interested to know why the Screen Actors Guild and the Artists Managers Guild and other groups interested in this have not discovered it before.

Mr. DALES. Senator, we would have been equally interested, had we discovered it before. Why we have not discovered it before is simply as I say based upon the fact that no actor has brought this to our attention. We do not have anyone in Washington reading over all such treaties. It just escaped us, and there has been no complaint under it, and we received of course no notice of hearing on any of those things. There was, I understand, a notice of the British hearings——

Senator LUCAS. Do you propose to discuss how seriously this Treaty will affect actors going to England?

Mr. DALES. All three of us—Mr. Abel, Mr. McCalman, and myself—will touch on it; yes. I think it can be taken for granted that there will be considerably more and historically has been considerably more interchange of talent between England and our country than with Sweden or Canada.

Senator LUCAS. All right, proceed. I will not interrupt you.

Mr. DALES. The second statement, that actors may go into another country for a short period of time and retreat with a large sum of money—I would like to say of that that if it is really the policy of this Government and the British Government to doubly tax high incomes earned in a short period of time under the circumstances provided in section 3 of article XI, then let the treaty say so, and let it provide for double taxation of all such high incomes, not just those of an actor.

On the other hand, it is of course the avowed purpose of this treaty to stimulate international trade, and any such exclusion of benefit, either against the actor or against all, would seem to us contrary to the spirit of the treaty.

It is a peculiar line that is drawn by section 3. May I give you an example? Robert Montgomery, an actor member of our board of directors, whose services for the studio by which he is employed have heretofore been confined to acting, solely, is now, as his next service for the studio, to direct a picture. Suppose for the sake of this presentation that this service is to be rendered in England by Mr. Montgomery for Metro-Goldwyn-Mayer, as a director: Mr. Montgomery would have the full benefits of article XI. Section 3 would not operate to deprive him of them, as a director. If, however, he were to act in this picture, he would be deprived of those benefits. What is the difference between an actor and the director of a picture, that should make this so? What also of the writer and the producer of that picture, as compared to an actor? What is the feature that distinguishes the actor from all the rest? It cannot be the personality, for often one person acts and directs, acts and writes, or acts and produces. It cannot be the rate of salary, because I assure you that, as a class, directors and writers fare much better than actors.

Well, then, the case seems to us to be this—a measure is proposed by the United States negotiators—for what purpose, and to whose benefit? To gain revenue for our country? I doubt it. Under the restricted circumstances which bring section 3 into play, that is to say, taking one side of it, an American actor's going to England for an American producer, there is not enough revenue in the whole set-up to seriously contemplate. Did our negotiators then propose it as a trading point? Was it something they offered England in return for

something of value to us? The answer to that is "no"—for you will hear from others today that England had no original thought of such a proposal, and as I understand it, eventually, only accepted it as a rather harmless "novelty"—that word is theirs—proposed by the United States and considered by England not important enough to make a point of.

In return, then, for this questionable asset to the treaty, should our Government brazenly discriminate against a proud class of its citizens—30,000 of them? If it is done—and this is our fear, Senator Lucas—a precedent will be set—a dangerous and unjustified precedent.

On behalf of all actors in the entertainment field, I ask that you and this committee give this matter your most earnest reconsideration before returning it to the Senate.

Senator Lucas. The trouble is you already have a precedent in the Canadian and Swedish treaties.

Mr. Dales. We have a precedent—a rather unimpressive precedent, I would think.

Senator Lucas. It may be unimpressive, because it has never been called to the attention of you folks out there who have been getting along very well under this and never noticed it very much. You fear now because of the high taxes I take it in England that somebody is going to get hurt.

Mr. Dales. Well, certainly so. I do not mean "unimpressive precedent" in only that sense. I mean it in the fact that there has not been a great interchange in the acting profession with the other two countries, Canada and Sweden.

As I say, it would seem peculiar that that clause, having existed in those treaties for all this time, has never been brought to our attention by any actor, by any agent, or by anybody else. No producer in Sweden has ever had difficulty getting an actor apparently because of a tax set-up.

Senator Lucas. Well, that is what seems rather peculiar to me. These conventions have been in existence all these years, and this is the first time, now, that you gentlemen have come in here to enter objections to it.

Mr. Dales. For the first time, Senator, once more, to our knowledge of the existence of any such a thing; and again, I am not a tax expert on any taxes. I certainly am not, on Swedish and Canadian taxes; and it could well be——

Senator Lucas. I am a little surprised that your wide-awake crowd would sleep on their rights all these years.

Mr. Dales. If we had been hurt by them, I can assure you we would have hollered.

Mr. Abel. I do not ever remember of any American actor going to work in Sweden.

Mr. Dales. That is the point.

Mr. Abel. Only a very few American actors have had any trouble with Canadian taxation, that I know of.

Senator Lucas. Are there any questions, Senator, you want to ask this gentleman?

Senator La Follette. No.

Senator Lucas. The next witness.

STATEMENT BY WALTER ABEL, STAR OF STAGE, SCREEN, AND RADIO

Mr. ABEL. I appreciate this privilege. I would like to have about 4 minutes. I should think that would do it.

I am the "horrible example," so will you excuse me if I speak personally at the beginning. I have been an actor since 1917. I have appeared in every form of entertainment—theater, vaudeville, motion picture, radio, and television—and through the medium of the motion picture, my "unique and extraordinary personality," as it states in my contract, has been known throughout the world, by the evidence of my fan mail, though since last October I escaped to the East, from over 10 years in California, because I wanted to resume a career; I have been spending my time largely in New York, and some in London.

In 1930 I appeared in an American play in London. We were one of three American plays, and three—they were all-American casts. Also, at the same time, the two London vaudeville theaters, and the vaudeville theaters in every large city in Engalnd and Ireland and Scotland and Wales, had, I should say, in some cases, half the bill made up of American actors. In 1930, Will Rogers was the toast of England, from the royal house down to every cabbie in the street. As an actor, having had that experience, I want to say that the hospitality extended by England—we have never enjoyed anything greater. Flattery was never greater, the money was never greater. All of that was in a tradition that goes back a great many years. Edwin Booth's "sweetest triumphs," in his own words, were his successes at Drury Lane many years ago. John Barrymore's personal satisfaction was never so great as when his Hamlet was acclaimed in London.

Now, between the periods of those gentlemen's careers in London, the American theater has been represented by plays, and by vaudevillists, in a traditional and historical movement to England every year. The American vaudeville actor, at the finish of his spring season in America, had a full summer season in London, and as I say, there is no welcome like the English public's; but never has the American actor received the distinction and the seeking out that he has received in article XI, section (3) of this convention. Unless there be other reasons he is reconverted to the role of a rogue and a vagabond, as the statutes of England and the State of Pennsylvania still let stand in their books—statutes that at one time denied him the privileges that his fellowmen enjoyed.

Yet this actor's business is one of the biggest and most constant and most international, in good times and in bad, in wars and in depression. Through the war he has gained a greater international public than he has ever known. In England and all over the Seven Seas he has played and played. There is no question but that this business is big business. The securities that represent the ownership of the medium in which he does his playing, the theaters, the films, and the air—the securities which represent the ownership of these things are freely traded in markets all over the world. The profits of these things are corporate and have certain exemptions. But this act within the United Kingdom denies the actor the traditional and historical opportunity to practice his art and earn its income on an equal

basis with other employees. ay, when his fellow taxpayer—any other American—businessma -may go to the United Kingdom, earn what he can for himself within 183 days, and return to the United States with all his compensation, and pay only his United States tax, with the blessing of the United Kingdom should not the same be true of the actor? This, in the face of the traditionally known welcome we have enjoyed in England, is just not understandable to all of us.

On Monday, by chance I ran into Mr. John Harding and his wife, who had just arrived from England with the Marquis of Queensbury. I had never known the gentleman before. Mr. Harding occupies in the British theater what, let us say, Mr. Schubert does in the American theater. I had never met the man. We started talking, and I said that I was going down to Washington to the inquiry into section 3, and he said, "Oh, my God! That is something that we don't understand." Now, this man has just arrived from England to pursue a theatrical business in this country, and that expressed his indignation at the fact that the British have allowed that to appear in the convention. He could not understand, because he himself said, "We need American actors as we have always needed them, to appear in the London theater, in the English theater, because we need that new blood in our theater, and we have always welcomed it." Not only that—the American actor not only appears in person in England, but the American actor on the film occupies 80 percent of the playing time in all English moving-picture theaters. He asked what he could do about it, and he volunteered without any suggestion from me to telephone to Mr. Will Hay, the president of the Variety Artists Federation of England, which he did on Tuesday morning at 6 o'clock, and he called me yesterday to inform me that Mr. Will Hay had called an emergency meeting of the Variety Artists Federation, which represents most of the actors in England. This morning I received this cable from Mr. Will Hay:

WALTER ABEL,
Washington, D. C.:

Any reduction in tax making possible an interchange of artists between United States of America and Britain would greatly benefit entertainment industry in both countries. Wish you every success.

WILL HAY,
Vice President, Variety Artists Federation, Unltd.

Now, we are not asking any more than is given to any other American businessman. We cannot understand why we should be singled out in the face of the traditional experience which is ours and the welcome given to us by England. It is incomprehensible to us. If we were taxed the same as every other American businessman is taxed we would certainly accept those conditions; but how can this difference exist?

Thank you.

Senator LUCAS. Mr. McCalman.

STATEMENT BY ADRIAN McCALMAN, ARTISTS MANAGERS GUILD

Mr. MCCALMAN. Senator Lucas, I represent the Artists Managers Guild, which is an association of managers of members of the "talent groups"—actors, writers, directors, producers, and anybody connected with the motion-picture business, the radio business, musicians, and so forth—in fact, the entertainment world.

First, I would like very much to answer the question that you asked Mr. Dales: Why have we not found out about the Swedish and Canadian treaties before? And, in fact, why did we not find out about this particular British treaty until November of last year?

The answer to the first as to the Canadian and the Swedish Treaties is the obvious answer, that because we do not send people in the motion-picture industry into Sweden or Canada to render their services in either of those countries we would have no reason to have any knowledge of provisions in those treaties similar to article XI of the proposed British-American Treaty.

The instant British-American Tax Treaty was negotiated during the war when we likewise did not send actors in the entertainment industry into Great Britain and it was negotiated with such secrecy between the two countries that we had no notice of anything connected with the treaty until just prior to November 1945. The question was raised in the transcript of the hearings held before this subcommittee in the spring of 1945 by two witnesses, Mr. Franklin Cole, an economic consultant of New York City, and Mr. Percy W. Phillips, of the American Bar Association, regarding the secrecy surrounding the negotiations of this treaty and the lack of publicity concerning it. You, Senator Lucas, on page 63 of the transcript, asked Mr. King whether it was customary to negotiate such treaties in secret. Mr. King replied that it was customary and that foreign governments insisted upon secrecy. He further stated that no publication of the terms of the treaty is made until it arrives in the Senate in order to have regard for senatorial secrecy in these matters until they are made public.

Mr. Stam made a recommendation appearing on page 77 of the transcript of previous hearings held before this subcommittee which was numbered "Fourth." He stated that it might be helpful if some study of income-tax treaties could be made in the preliminary states by independent groups so that valid objections could be remedied without resulting in the withdrawal of the entire convention. I heartily approve of that recommendation. During the war, the Bureau of Internal Revenue consulted many industries, including ours, to obtain advice on how to administer the Wage and Salary Stabilization Act, and while this may not be a precedent, nevertheless, the custom of hearings in both branches of Congress before legislation is introduced would certainly be helpful in connection with future negotiations of income-tax treaties.

We first saw a copy of the instant British-American Tax Treaty about the second week in November 1945. I came East on or about November 21, 1945, to see if I could ascertain why section 3 of article XI, discriminating against public entertainers and athletes, was included in the treaty.

Before I take up the question of the discrimination set forth in section 3 of article XI, may I give you some examples of how sections 1 and 2 of article XI can come into use in the entertainment industry, and particularly in the motion-picture industry:

1. An American motion-picture producing company with a permanent establishment in the United States and none in England may decide to produce a motion picture in England. Actors quite often are employed by motion-picture companies under a contract for an aggregate period of 7 years. The contract usually requires the actor

to perform his services anywhere in the world that his employer may designate. In this particular instance, the employer, the American motion-picture company, in producing a picture in England where it has no permanent establishment, transports sufficient of its employees, including actors, to England to make a picture. Everyone connected with the making of the picture in England, except the actors, will be governed by the provisions of section 2 of article XI of the treaty, and since the picture usually takes much less than 183 days to make, everyone, except the actors, is not subject to United Kingdom taxes, but the actors are, because of the inclusion of section 3 in article XI.

2. Another case is the example of an actor who is employed by an American company with no permanent establishment in England on the same 7-year contract mentioned above. Assume that his salary is $1,000 per week and the American company makes a deal with a British producing company to loan to the British company the service of the actor for a period of 10 weeks. If the actor's net taxable income for the year was $40,000 and he was in England for 10 weeks, thereby receiving $10,000 for performing his services in England, he would be subject to a tax of, roughly, $6,000 by the United Kingdom, and, under section 131 of our Internal Revenue Code, he would only be allowed a credit against his United States income tax of the amount of tax which he would have paid to the United States had the $10,000 been earned by the actor in the United States. In this particular instance, his credit would be approximately $4,000 and the actor suffers a loss of $2,000 because of his payment of taxes to the United Kingdom. In this instance, the actor has the alternative of working in England and taking a loss of $2,000 or of refusing to work in England and breaching his contract with his employer.

The money paid the actor who is in England for 10 weeks making a picture is usually paid to the actor in Hollywood and is never received by him in England, and therefore he should not be taxable.

Let me show you the difference, right there. I will give you another example. We have also what we call in the industry—and incidentally, anything I say about the motion-picture industry can be applied substantially to any other branch of the entertainment industry—in this particular example——

Senator La Follette. Mr. Chairman, I am very sorry, but I have got to go to a conference on the Philippine Trade Act, but I shall read the testimony when it is available.

Senator Lucas. All right, Senator La Follette.

Mr. McCalman. The third example is that of a free-lance actor. The free-lance actor may enter into a contract with the British producer to render his services in England. Assuming that the actor's going rate of salary is $2,000 per week on a 5-week guaranty for one picture, he is in a position to bargain with the British producer for a higher rate of salary than his customary salary in order to offset the loss he would sustain from the payment of taxes to the United Kingdom. Thus, this situation differs from the other two examples and this particular actor does not come under the terms and provisions of article XI at all because he is employed by a British producer and not an American producer. In this instance, he is in a position to say "I will either perform my services for you in England at a higher salary than my customary salary of $2,000 per week," or, "I will not perform my services at all because if I do, the payment of United Kingdom

taxes by the amount the reduced credit allowed me by the United States will cause me to suffer a loss in net income." In other words, he is in a bargaining position—to break even, on the British tax that he has to pay, which as you know is higher than the American tax, and probably will be for some time.

Senator LUCAS. The producer would be compelled to absorb that, would he not?

Mr. MCCALMAN. Sir?

Senator LUCAS. The producer would be compelled to absorb the tax?

Mr. MCCALMAN. That is a question that I cannot answer. We have had it up.

Senator LUCAS. I am only suggesting that, in view of the fact that you are talking about this fellow bargaining. He is going to bargain before he goes. Somebody is going to have to absorb that tax, some place.

Mr. MCCALMAN. Yes; you are right. In that situation, that is correct. I mean, he has a choice. If the British producer will not pay sufficient to give him a net before United States taxes of what he ordinarily would have received here for a picture, and he is working over here, he can say to the British producer, "I won't take the job—or I will, on my own terms."

Senator LUCAS. I do not think he would be repudiating his contract, under those conditions.

Mr. MCCALMAN. My last example was that of a free-lance actor.

Senator LUCAS. Oh, I see.

Mr. MCCALMAN. Yes; you are right. In the last example I gave you, the free-lance actor has a choice. If the British producer will not pay him a salary sufficient to return him a net income equal to what he would have received had he performed his services in the United States, he can say to the British producer, "I will not take the job." However, in the first two examples, he has no freedom of choice unless he intends to breach his contract with his American employer.

Reverting back to my activities in Washington, in November and December 1945—I am not a tax expert and I knew nothing about income-tax treaties at that time. I conferred with almost every representative of the executive branches of this Government, with a few possible exceptions, who had negotiated this treaty on behalf of the United States, including Mr. King and Mr. Mitchell, of the Bureau of Internal Revenue. I also conferred with Mr. M. E. Bathurst, the legal adviser to the British Embassy in Washington, in order to obtain from him the British views with regard to section 3 of article XI.

In the latter part of November, I had a conference with Commissioner of Internal Revenue Nunan. I told the Commissioner that I was representing the Artists' Managers Guild and the Screen Actors' Guild and that we were very concerned as to the reason for the inclusion of section 3 in article XI of the treaty and the possibilities of having said section deleted therefrom. At Commissioner Nunan's request, I prepared a memorandum for him which was the subject of discussion between the Commissioner, Mr. King, and myself the day after my first meeting with the Commissioner. At this second conference, the Commissioner advised me that he would not initiate negotiations with the British at that time looking toward the deletion

of section 3 of article XI of the treaty. The Commissioner did say that he thought that I was right that section 3 of article XI was discriminatory against actors. He said, however, that this should not deter me from doing anything I could to accomplish my mission, and his advice to me was to see everyone in the Government connected with the matter. I told him whom I had already seen and he suggested to me that I see one of the persons in the Treasury Department and interview him, and requested Mr. King to make an appointment with that person for me.

In the memorandum I had given him, I had set forth my understanding of a conversation I had had with Mr. Bathurst, and I want to read that particular part of the memorandum which came into question, if I may; and this is an excerpt from my memorandum to Commissioner Nunan:

> In conference with Mr. Bathurst, legal adviser to the British Embassy, who drafted the treaty, I was informed that the British questioned section 3 of article XI, when it was proposed by the United States, but nevertheless finally waived any objections that they had at the time of the negotiations. I also asked Mr. Bathurst, assuming the United States could be persuaded to delete section 3 of article XI, would the British now object to such deletion. Mr. Bathurst, of course, would not make a binding statement, merely expressed his own personal opinion, which was to the effect that he knew of no reason why the British would now have a different attitude regarding section 3 of article XI, and he could think of no reason why the British should change their mind in the interim between the negotiations and the present time, being a period of approximately a year, and therefore his conclusion was that the British would react favorably to the deletion of section 3 of article XI if the United States requested them to do so.

The Commissioner said that Mr. King had read the above-mentioned part of my memorandum to Mr. Bathurst of the British Embassy over the telephone. Mr. Bathurst informed Mr. King that I had misunderstood him and consequently had misquoted him. After trying to get Mr. Bathurst on the telephone several times, I addressed a letter to him under date of December 5, 1945, and in that letter set forth the above-quoted paragraph that I have just read to you, requesting him to address a letter to Commissioner Nunan, with copies to Mr. King and myself, setting forth the understanding of our conversations regarding the matter of the original position of the British in the negotiations concerning section 3 of article XI and his understanding of their present position. Instead Mr. Bathurst addressed a letter to me, dated January 18, 1946, which reads as follows:

> DEAR MR. MCCALMAN: I regret that your letter of December 5, 1945, has gone so long unanswered. I have been waiting to obtain from London the views of the Government of the United Kingdom on their probable reaction to any representations which might be made with a view to deleting paragraph (3) from article XI of the Income Tax Convention between the United States and the United Kingdom. A telegram has recently been received by the Ambassador stating categorically that the United Kingdom would object to its deletion.
>
> When you called upon me to discuss this matter I stated that no one at this Embassy could speak for the inland revenue authorities of the United Kingdom, but that I could state my personal thoughts based on my recollection of the final stages of the double taxation discussions. I said that, although the paragraph in question had initially been proposed by the United States participants in the discussions leading to the treaty, the United Kingdom representatives on learning the reasons for the proposal agreed to its inclusion and must therefore be considered to have been in favor of it. Apart from any other considerations, the United Kingdom authorities would, I stated, in any case be reluctant to consider altering the treaty which had been signed and was about to be ratified by the United Kingdom and enacted into law. When you asked if the United

Kingdom would be prepared to discuss deletion of paragraph (3) of article XI if the United States proposed reconsideration of it, I said that the United Kingdom would not, of course, decline to discuss any proposal put forward by the United States, and that any such proposals, if they were in fact made, would receive consideration, though probably reluctantly.

It therefore appears that to the extent to which you believed that I believed that the United Kingdom would actually react favorably to any proposal for the deletion of paragraph (3), you carried away—no doubt through my failure to express myself clearly—a wrong impression of that part of our conversation. I think what I have said above accurately summarizes the points of our discussion. I think the misunderstanding must have originated in your believing that the United Kingdom delegates to the taxation discussions had at one stage expressed opposition to the proposed paragraph (3) of article XI. I do not think at any time their attitude could be described as opposition since at first they did not fully understand the reasons for the proposed insertion, but when the proposal was explained to them, they agreed to its inclusion. If the United States Government had not made the proposal for the inclusion of paragraph (3) of article X, then you are correct in thinking that I do not believe that the proposal would have been made by the United Kingdom since it appeared to them as a novelty of which they had not thought.

I am sorry that you left Washington without my being able to see you again. I returned your telephone call on December 3 but you were out, and I received no message to the effect that you had called on December 4. If I had done so I would, of course, have called you back.

With kind regards,

Yours sincerely,

M. E. Bathurst, *Legal Adviser.*

As I understand Mr. Bathurst's letter, the United Kingdom is anxious to have the United States approve the treaty. The British did not initiate section 3 of article XI. They did, however, on or before January 18, 1946, feel that the treaty should be passed in its present form.

My own personal opinion is that the United Kingdom would not, at present, object to the deletion of section 3 of article XI of the treaty if this subcommittee and the full Foreign Relations Committee so recommended and the request was made through proper diplomatic channels. I base that opinion on discussions which I have had with a British tax man who was recently in Hollywood and who had initiated an investigation in London to ascertain the reasons for the inclusion of section 3 in article XI of the treaty. His investigation was quite independent of mine in Washington. Also, British producers are anxious to contract for American actors to appear in their pictures for the obvious reason that the box office appeal of an American actor will assure them some market for their pictures in the United States. Certain artists' managers who have been approached by British producers, looking toward negotiations for the services of American actors in British pictures, have advised the British producers of the terms of section 3 of article XI.

Senator Lucas. It is to the advantage of the British actor; is it not?

Mr. McCalman. Yes, sir; well, no. That is not quite right. It is not to the disadvantage of the British actor. Since the British actor pays American taxes on compensation received for services performed in the United States, and since American tax rates are lower than tax rates in the United Kingdom, his credit for American taxes paid under article XIII of the treaty would be less than the British tax paid by him on the same amount of money earned and, therefore, he does not lose any money as does the American actor who performs his services in England under circumstances which would bring him under the terms of section 2 of article XI if section 3 was deleted.

Senator LUCAS. No, I do not follow you.

Mr. MCCALMAN. Let me make myself clear. This is the example of the actor who is under a term contract.

Senator LUCAS. If there is no advantage to the British actor, and it is a disadvantage to the American actor, then I do not quite follow you. If there is no advantage to the British actor, it comes to the same thing, and there is a disadvantage to an American actor going to England.

Mr. MCCALMAN. Speaking taxwise.

Senator LUCAS. That is what I am talking about.

Mr. MCCALMAN. Taxwise, financially, he is at no disadvantage, because on $40,000 in England he will pay X dollars—I do not know how much.

Senator LUCAS. Well, I have a table, here, for instance. We will just use the $40,000 example. I understand from this table, if an American actor spent 3 months in the United Kingdom and he was getting $40,000 salary in this country, the United Kingdom tax would be $4,700.

Mr. KING. Against the United States tax we allow about $3,780 of the total United Kingdom tax of $4,700; that is to say, we allow a credit for the United Kingdom tax up to, but not in excess of, the amount of the United States tax on the portion of the income earned in the United Kingdom.

Senator LUCAS. All right. Now, what I want to know is the answer to the question that I asked a moment ago—what does the American actor, whose annual income is $40,000 and who spends 3 months in the United Kingdom, have to pay in taxes? What does the British actor, who has the same income and who comes to the United States and spends 3 months, have to pay in taxes?

Mr. KING. On the first illustration, the United Kingdom tax paid by the United States actor would be $4,700.

Mr. MCCALMAN. How much money did he receive?

Mr. KING. On the $40,000 we are talking about.

Mr. MCCALMAN. I know, but how much money did he receive while rendering his services in England?

Mr. KING. It would be three-twelfths of $40,000.

Mr. STAM. $10,000.

Mr. ANEL. That is right.

Mr. MCCALMAN. Thank you.

Mr. KING. Then, applying our credit formula, he can use $4,700 of his British tax—or, no—he can use $3,778.

Senator LUCAS. That is what he is allowed in this country?

Mr. KING. That is what he is allowed in this country. So there is a difference of a little less than $1,000 that he pays. He pays about $1,000 more in aggregate tax than he would pay had he not rendered services in the United Kingdom.

Senator LUCAS. All right, now, the reverse of that?

Mr. KING. To reverse the picture—we haven't a table on that.

Senator LUCAS. Would he not get a credit on it? What I want to know is, would not the British actor get the credit of $1,000 if he were in this country? A moment ago, you said there was no advantage to the British actor.

Mr. ANEL. He is not hurt.

Mr. McCALMAN. No; we are in agreement as to what you say. What I say is this, that the British actor would pay $4,700 tax in England, would he not, the same as the American actor, on that particular 3-month period; is that correct, Mr. King?

Mr. KING. Yes; that is correct.

Mr. McCALMAN. All right. Then the British actor coming over here pays to the United States $3,778, and he returns to London?

Mr. KING. He would pay the United States tax upon $10,000 which would be about $2,700.

Mr. McCALMAN. Maybe that is not correct. Maybe you had better explain it. But what I am saying is that the British actor working in America, under the circumstances set forth in section 1 of article XI, pays an American tax lower than the British tax he is obliged to pay and, therefore, when he credits his American tax to his British tax it makes no difference to him because he is obligated to pay his own country the higher rate. On the other hand, the American actor in the reverse situation loses money.

Mr. KING. I might try to summarize it this way. We have covered the United States actor. Now take the British actor who comes to the States. He is taxed here on the time basis. If he is here 3 months, we take three-twelfths of his income.

Senator LUCAS. Now, let us get right back to the $40,000. I want to get right back to that. He is taxed three-twelfths?

Mr. STAM. Three-twelfths of that would be $10,000.

Mr. KING. All right; he is taxed on $10,000 when he comes over here.

Senator LUCAS. Now, what rate?

Mr. KING. It is our graduated rate on $10,000. Prior to the treaty, that British actor, in figuring these taxes in Britain, could only deduct from his income the United States tax. Now, he can deduct from the British tax the United States tax. In other words, under the treaty he gets the same credit system applied to him that the United States actor gets under our law and under the treaty, so definitely the British actor is better off than he was before the treaty.

Mr. McCALMAN. That is right, but you are talking about credits under article XIII of the treaty and I am talking about article XI.

Mr. KING. Another way to summarize it is that both the actors pay the British tax, if you want to put it that way.

Mr. McCALMAN. That is right, but you are still talking about article XIII.

Mr. KING. They pay the higher of the two taxes.

Mr. McCALMAN. That is right.

Mr. KING. I think, up to this point, enough attention has not been given to this credit system. It underlies our whole treaty. The United States has long employed a credit system as a part of its domestic legislation and the principle has been carried into the treaties. We continue to eliminate double taxation in many instances through the credit system, in others through an exemption system. Now, it should be made especially clear that the actors are merely having applied to them a credit system, as are numerous taxpayers under this treaty. I think it is entirely unfair to say that anyone who has a credit system applied to him is being treated as a rogue, and one who has an exemption system applied is not being treated as a rogue. I think that the comparison is very unfair.

Senator LUCAS. Let me ask you, right on that point, Mr. King. Give me some examples of other individuals who are taxed under the credit arrangement that you are now discussing.

Mr. KING. A very interesting comparison could be gotten up along that line with a little study. I might note a few instances that happen to come to my mind immediately. Take a case of the American automobile concern or, say, a tobacco concern, a bank—in fact, any concern, except a United States shipping company, which has a branch in Britain. It is taxed in Britain on its British income and in the United States on the same income. The United States deducts from the United States tax on that income the British tax. In other words, the credit system is invoked.

Senator LUCAS. Now, let me ask, from the standpoint of taxation would these gentlemen, here, represented by these men, be placed in the same category as the example you have given?

Mr. KING. Absolutely.

Mr. DALES. No.

Mr. MCCALMAN. He is right. Mr. King is again discussing article XIII, not article XI.

Mr. KING. They certainly are exactly in the category; you are placed under the credit system.

Mr. MCCALMAN. Surely; that is right.

Mr. DALES. I was just curious to see whether Mr. King could clear it up for us. In one case I understood we were talking about employees. Put your case of the employee, and that of the banking company.

Mr. KING. I am coming to a lot of those illustrations. The Senator asked me for some illustrations. That is No. 1. We can go on here by the dozens perhaps. Some are handled through the credit method, some through the exemption method. Now, to continue with my illustrations, turn to the shipping company, where double taxation is eliminated in an entirely different way. The treaty says that as to the income of a United States shipping company, as to its ships registered in the United States—and the same is true of an aircraft company, I might say—Britain will not tax the income earned in Britain. Double taxation is eliminated through the exemption method, but that does not prove we have got a grudge against automobile companies, banks, and dozens of others, in contrast to the shipping company.

Another illustration is that we would eliminate double taxation in the case of teachers and professors who come here or go there not more than 2 years, through an exemption method, by making them nontaxable in the country they go into, and taxable by their home country. It is a practical problem affecting exchange teachers and not a great deal of revenue is involved. Likewise alien employees of the United Kingdom Government rendering services in the United States are wholly exempt from United States tax with respect to their compensation for such services.

Take the case of exemption of interest at source. There is very broad provision, where we generally exempt interest from taxation at the source. We have, say, a debtor here, a creditor in England: and interest paid here goes out of the United States tax free. However, where interest is paid to a British company that owns more than 50

percent of the stock of the United States company we turn to the credit method. We tax; the British tax; the credit avoids double taxation. That is what your case is based on. It dates back to the 1936 law, where, in deciding what to do with the alien who is coming into this country, and paid from abroad, the whole field was discussed, including the actor field, and it was decided not to give an all-out exemption but to give it within limitations; then, if a party were here not more than 90 days or made no more than $3,000, he would get his exemption, but otherwise we would have to handle it through a credit system.

Senator LUCAS. Right at this point I want to put into the record an excerpt from the Senate Finance Committee report on the bill to which Mr. King has reference.

(The law referred to is as follows:)

REVENUE BILL OF 1936

[Committee Rept. No. 2156]

* * * * * * *

One other change in the taxation of nonresident aliens is recommended by your committee in the form of an amendment to section 119 (a) 3 of the House bill. This amendment would operate to exclude from the definition of income from sources within the United States compensation received by a nonresident alien individual for labor or services performed in the United States under an employment or contract with a nonresident alien individual or a foreign partnership or corporation, provided such services are rendered by such nonresident alien individual while temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year, and that the aggregate compensation for such services does not exceed $3,000. The purpose of this amendment is to permit residents of other countries to make brief visits to the United States for business purposes, such as the buying and selling of goods, without being subject, before leaving the country, to a demand for payment of tax on their compensation during the period of their stay here. Numerous cases of this character arising under the present law have created irritation and ill will quite disproportionate to the slight revenue involved. The limitations contained in the amendment are, it is believed, adequately drawn to prevent any serious abuse of the exemption. This change is consistent in purpose with the amendment to section 211 (b) which the committee has recommended.

Mr. KING. I should like to add right there that in conforming the terms of tax conventions to the tax systems of the contracting countries it is often found impracticable to adopt provisions which are uniformly logical and consistent with one another, resulting in the adoption of compromises, the background of which it is necessary to understand in order to properly appraise them.

Senator LUCAS. Let me ask you, right there, Mr. King, were the Swedish and Canadian treaties drawn on the law, or under the spirit of the law as we expressed it in the statute book in 1936?

Mr. KING. I would say the prime influence was the lead that we thought we had in the 1936 law.

Senator LUCAS. Now, Mr. McCalman, I do not think you had finished.

Mr. MCCALMAN. No, sir.

M. KING. Could I add just one thing, before I lose it?

Senator LUCAS. Yes; that is perfectly all right. This is more or less informal.

Mr. KING. Very little has been said about our credit system. Much was said about the actor being doubly taxed; then the statement rested there. Our view is that where the one tax is removed

through a credit system there is no double tax, consequently our position is that the actors are not doubly taxed. They are it is true paying the higher of the two taxes incident to the application of the credit system, but I believe that is the fair statement, rather than to say that they are doubly taxed.

Mr. McCALMAN. I agree to that. Mr. King, however, is not discussing sections 1 and 2 of article XI as applied to all residents of the United States, except actors and athletes. He is discussing article XIII which is an entirely different matter.

Senator LUCAS. In 10 years from now, if the tax situation is just reversed, the American actor would be getting the benefit rather than the British actor?

Mr. McCALMAN. That is right.

Senator LUCAS. That is, if the tax situation were just reversed.

Mr. KING. Thus, if at that time, or any other time, the United States tax is higher than the United Kingdom tax then the taxation by the United Kingdom of a United States actor would not make any difference in his aggregate tax liability.

Senator LUCAS. Then there is hardly a justification for the statement that this special class of people that are being taxed under this section of the convention are being discriminated against, compared to other people who are also being taxed under the credit system rather than under the exemption system?

Mr. KING. That is correct.

Mr. McCALMAN. Senator, may I answer that, sir? I will agree with practically everything Mr. King said, up until the last statement. Mr. King has discussed sections of the treaty other than those contained in article XI. It is true that under article XIII of the treaty a "free lance" actor may contract with a British producer to render his services and the tax situation will be governed by article XIII. We have no quarrel with that because article XIII does not discriminate against residents of either country as a class.

Section 2 of article XI, however, if I may use an example, states, in effect, that if I were a salesman, a resident of the United States, employed by an American aircraft company and I took a trip to England and was successful in selling $20,000,000 in airplanes for my American company, on which I was paid a commission of 5 percent, and I did all this within a period of less than 183 days and subsequently made a million dollars, I would not be liable for any United Kingdom taxes. Obviously I would have to pay taxes to the United States.

On the other hand, if an actor, a resident of the United States, employed by an American company, renders his services in England and makes $10,000 for 10 weeks' services he is required to pay taxes to the United Kingdom, as we read section 3 of article XI. What in the world is the difference between the airplane salesman who makes a million dollars and the actor? Neither one of them should be subject to United Kingdom taxes and that is why we are objecting to section 3 of article XI.

Senator LUCAS. You contend that you are being discriminated against because there are exemptions for other classes of people in the same category that you contend you are in?

Mr. McCALMAN. That is right. All other "residents" of the United States except actors are exempt from United Kingdom taxes where they are employed by an American employer and perform their

services in England during a period of less than 183 days in any taxable year. What we cannot understand is why the discrimination against actors in section 3.

Senator LUCAS. Are there any other statements Mr. McCalman?

Mr. MCCALMAN. I just want to make one closing statement, then I am through.

I understood from Commissioner Nunan, at the second conference held with him in November 1945 where Mr. King was present, that I could quote him as saying that if he were called upon by this subcommittee to testify he would testify on his own behalf that section 3 of article XI was discriminatory against actors and that such testimony would not bind the Treasury Department, the State Department, or any other department. He stated to me that I could quote him to anyone. I wired him from Colorado last Sunday night that I wanted to see him on Tuesday before this hearing. The Commissioner was not in town yesterday and I am, therefore, putting this in the record subject to Commissioner Nunan's correcting any statement that I have made as to his statement to me last November.

I believe, Senator, that if this subcommittee finds that they can recommend to the Foreign Relations Committee that article 3 is discriminatory and should be renegotiated, that through diplomatic channels and the proper representatives of our Government, we will be able to reach an accord with Great Britain rather easily on the deletion of it, from the conversations that I have had relative thereto.

Senator LUCAS. You may have had those conversations, but what about your letter that you read into the record?

Mr. MCCALMAN. That was on January 18, 1946, and considerable has been done in Great Britain about section 3 of article XI, as evidenced by the telegram received by Mr. Abel. Also, British producers have been put on notice by artists' managers in Hollywood that such a clause was in the treaty and transactions for the employment of American actors in British pictures have either not been made at all because of section 3 or have been made subject to the option of the actor to refuse to perform his services in Great Britain if section 3 is not deleted from article XI of the treaty.

Senator LUCAS. Mr. King, do you have anything to say further?

Mr. KING. Well, he drew a comparison between the traveling salesman and the actor. I think it is hardly worth while to go on and draw many other similar comparisons. It all comes back I believe to the question that those who are treated under the credit method can turn to those who are treated under the exemption method and begin to complain about it, and there are others who probably think they are in the same class as a teacher, and we can go on with that sort of comparison rather indefinitely. I hardly think that requires any further answer.

Senator LUCAS. Have you got a statement, Mr. Stam, or do you want to make a suggestion, one way or another?

Mr. STAM. No; I do not think so, except one thing that worries me a little, and maybe we can clear it up. As I understand, in England they regard these people, a lot of them, as exercising a profession, or not exercising a profession in the United Kingdom. As I understand it, there is very grave doubt as to whether any English tax would apply at all. In cases where no British tax is collected, it should be made clear that an American tax is paid.

Mr. McCALMAN. You are talking now about an English actor working over here?

Mr. STAM. That is right.

Mr. McCALMAN. I cannot answer you; I do not know if England collects a tax under such circumstances.

Mr. STAM. There is a little conflict in the cases, but it seems to be the general rule that if they are exercising a profession in the United Kingdom they would be taxable on their income from outside the United Kingdom, whereas, if they were not exercising a profession in the United Kingdom, they may not, if the money is not remitted to England.

Mr. McCALMAN. Then you think that if section (3) of article XI were deleted that the United Kingdom should take steps to clarify that in their laws. That is the only suggestion I can make.

Mr. STAM. Some classification should be made, if this is true.

Mr. McCALMAN. I agree.

Mr. STAM. This, of course, not only includes movie actors, it includes prizefighters and people like that, who come over to this country and put on entertainment and take quite a lot of money out of the country, and it would seem such income should bear a tax. The question might also come up, there, as to whether or not somebody should not collect a tax on the income. That is the real problem.

Mr. McCALMAN. From the gross revenue standpoint for both countries, I do not know of any statistics which will show which country will get the most revenue. It looks to me, as far as the entertainment industry is concerned, that for the next few years, it is practically a stand-off, and that the dollar revenue for either country will not be very different if section 3 is deleted from article XI. Of course that is simply my opinion, and as I say, I have no statistics.

Senator LUCAS. Do you have any figures to show how many actors from America go to England annually to perform services there?

Mr. McCALMAN. No, sir; we do not; and of course, during the war there were practically none at all, and the only ones who did go were in the USO units.

Senator LUCAS. You made a statement that only 400 out of 8,000 in the industry obtained a salary of more than $15,000 per annum. Do those actors obtaining a smaller sum than $15,000 go to England?

Mr. DALES. Oh, yes.

Senator LUCAS. Frequently?

Mr. DALES. Oh, yes.

Senator LUCAS. Quite a few of them, I presume.

Mr. DALES. Quite a few of them, particularly variety actors and that sort of thing. The truth of the matter of course is that the average motion-picture actor is not just doing that. He works on the radio, he works on the stage, and so on, and those people interchange in their profession between the various types of entertainment, and also between the countries. It is true, as Mr. McCalman says, that because of the war there just are not any statistics.

Senator LUCAS. Yes, I understand.

Mr. DALES. And it is anticipated, I think, by the industry internationally that there will be considerably higher interchange of actors, not necessarily stars, only, but of all types, that will play in English casts.

Senator LUCAS. That is what I had in mind.

Mr. DALES. Yes.

Senator LUCAS. I was wondering about those who were under the $15,000, as to what the interchange would be along that line, and I presume there would probably be more actors under the $15,000 than there would be over it.

Mr. DALES. It very well could be.

Mr. MCCALMAN. Oh, yes. Actually, Senator, the figures are only as to the motion-picture industry.

Mr. DALES. That is right.

Mr. MCCALMAN. The public hears of band leaders who receive fairly large salaries, but the musicians who make up the personnel of a band, the members of symphony orchestras, concert singers and others of similar nature are not highly paid artists. These are the people who really should be protected in any treaty involving income taxes.

I will close on that, and may I introduce into the record a brief which is in support of our position, which I sent to the members of the Senate Foreign Relations Committee before their meeting on February 6, when they recommended that this treaty be resubmitted to this subcommittee?

(The brief in support of proposal to delete section 3 of article XI of the treaty, submitted by Mr. McCalman, is as follows:)

A CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON ON APRIL 16, 1945—EXECUTIVE D

BRIEF IN SUPPORT OF PROPOSAL TO DELETE SECTION 3 OF ARTICLE XI OF A CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND, FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON ON APRIL 16, 1945

GENERAL

The above-designated Treaty was read for the first time on the floor of the Senate on April 24, 1945, and referred to the Senate Committee on Foreign Relations.

On April 26, 1945, the Treaty was made public. Hearings were held before a Subcommittee of the Senate Committee on Foreign Relations constituted as follows:

Alben W. Barkley, Chairman (Kentucky)
Carl A. Hatch (New Mexico)
Scott W. Lucas (Illinois)
Robert M. LaFollette, Jr. (Wisconsin)
Wallace H. White, Jr. (Maine)

The above-mentioned hearings were held on May 23 and June 13, 1945, at which time the following witnesses appeared and testified briefly:

Mitchell B. Carroll, Special Counsel, Tax Committee, National Foreign Trade Council, Inc., New York, N. Y.
Franklin Cole, Economic Consultant, of Cole, Hoisington & Co., New York, N. Y.
Percy W. Phillips, Chairman, Section on Taxation, American Bar Association, Washington, D. C.
Elden P. King, Special Deputy Commissioner, Bureau of Internal Revenue, Washington, D. C.
Colin F. Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation, Washington, D. C.

On June 30, 1945, the above-mentioned Subcommittee reported back to the full Committee with a recommendation that the Treaty be transmitted to the Senate for its favorable advice and consent and without amendment. As of January 14, 1946, the Treaty is on the Executive Calendar of the Senate.[1]

ARTICLE XI OF THE TREATY AND IN PARTICULAR SECTION 3 THEREOF

This brief contains no comment or criticisms on the Treaty as a whole. The only point considered and discussed in this brief is the grossly unjust and unexplained discrimination against public entertainers contained in Section 3 of Article XI of the Treaty. Article XI reads as follows:

(1) An individual who is a resident of the United Kingdom shall be exempt from United States tax upon compensation for personal (including professional) services performed during the taxable year within the United States if (a) he is present within the United States for a period or periods not exceeding in the aggregate 183 days during such taxable year, and (b) such services are performed for or on behalf of a person resident in the United Kingdom.

(2) An individual who is a resident of the United States shall be exempt from United Kingdom tax upon profits, emoluments or other remuneration in respect of personal (including professional) services performed within the United Kingdom in any year of assessment if (a) he is present within the United Kingdom for a period or periods not exceeding in the aggregate 183 days during that year, and (b) such services are performed for or on behalf of a person resident in the United States.

(3) THE PROVISIONS OF THIS ARTICLE SHALL NOT APPLY TO THE COMPENSATION, PROFITS, EMOLUMENTS, OR OTHER REMUNERATION OF PUBLIC ENTERTAINERS SUCH AS STAGE, MOTION-PICTURE, OR RADIO ARTISTS, MUSICIANS, AND ATHLETES. [Caps. ours.]

IF SECTION 3 OF ARTICLE XI IS NOT DELETED FROM THE TREATY PUBLIC ENTERTAINERS (AND ATHLETES) WILL PAY A GREATER TAX THAN ALL OTHER RESIDENTS OF THE UNITED STATES WILL PAY UNDER SIMILAR CIRCUMSTANCES

The tax rate of the United Kingdom is at present higher than the income-tax rate of the United States. In all probability the tax rate of the United Kingdom will remain higher than that of the United States for many years to come. At the present time, there is obviously no way of accurately forecasting the United States income-tax rates for the next few years, but it is a reasonable assumption that the tax rate in the United States will be reduced sooner than the tax rate in the United Kingdom will be reduced.

At the present moment certain United Kingdom motion-picture companies have contracted with certain United States motion-picture producing companies, to loan British stars to the American companies to perform their services in American pictures made in the United States, and to borrow from the American companies American stars to perform their services in British pictures made in the United Kingdom. The services to be performed will not ordinarily take over 183 days. In most instances they will take about 10 or 12 weeks.

The ordinary term contract in the American motion-picture industry *requires* the actor to perform his services in any part of the world designated by his employer. If Section 3 of Article XI is not deleted from the Treaty (as an example) an actor under contract to an American motion picture company loaned to a British motion-picture company to perform his services in England in a picture on behalf of his American company would find himself in this kind of a tax position: Assume that the actor was paid at the rate of $1,000 per week and that his total net taxable income would be approximately $10,000 for the taxable year, including the amount set forth below paid him while in the United Kingdom, and assume that the actor performed his services in the United Kingdom for 10 weeks, the American company (not the British Company) would pay the actor 10 weeks' salary of $10,000 in the United States and not in the United Kingdom. The contract for the actor's services in this instance is between the British Company and the American Company (not the British Company and the actor).

Section 3 of Article XI of the Treaty, as it is now written, excludes the actor from the exemption granted all other residents of the United States under Section 2

[1] On February 6, 1945, the Senate Foreign Relations Committee recommended that the Treaty be returned to the Subcommittee for further hearings. By unanimous consent on February 6, 1946, the Senate removed the Treaty from the Executive Calendar and returned it to the Subcommittee.

of Article XI, and accordingly the actor would have to pay United Kingdom taxes on the $10,000 that he earned while there.

Assume that the tax on $10,000 in the United Kingdom is $6,000. Let us assume that the actor owes the United States a total of $10,000 in income taxes on $40,000 net taxable income. The United States, under Section 131 of the Internal Revenue Code and Article XIII of the proposed Treaty, would allow the actor a credit of only $4,000 of the $6,000 of the tax paid to the United Kingdom, as provided in Section 131 of the Internal Revenue Code which states that the credit cannot be higher than the amount of tax which would have been paid to the United States had the money been earned and received by the actor for his employment in the United States. In other words, the credit would be $\frac{10,000}{40,000}$, or ¼ of $16,000, making a credit of only $4,000. In this instance, the actor stands to lose $2,000 because:

1. he is an actor, and
2. his employer, the American company has loaned him to a British company.

Assuming that the United States income-tax rate will be reduced sooner than the United Kingdom tax rate will be reduced, the spread will grow larger each year, and the actor will lose more money by payment of United Kingdom taxes.

The above illustration of an American motion-picture company loaning an actor to a British motion-picture company would apply similarly to any field of the entertainment industry which the provisions of Article XI would govern.

Transportation facilities before the war were largely confined to boat travel between the United Kingdom and the United States, which made exchange of public entertainers between the two countries difficult because of the time element. Within a very short time there will be available sufficient airplane transportation to enable residents of both countries to go back and forth in a matter of a few hours to transact business in either country. This will facilitate the exchange of public entertainers between the United Kingdom and the United States, and therefore the deletion of Section 3 of Article XI of the Treaty becomes most important to public entertainers.

Contrast the example given of an actor who is a resident of the United States employed by a United States employer performing services in the United Kingdom, with the example of a businessman who is a resident of the United States employed by a United States employer and who transacts business for his employer in the United Kingdom remaining there for less than an aggregate of 183 days during any taxable year, which would bring him within the terms of Section 2 of Article XI of the Treaty. Assuming that the businessman is the salesman for an American airplane company, he might conceivably negotiate orders for the sale of his company's airplanes to a customer or customers in the United Kingdom which orders we will assume aggregate $20,000,000. If the salesman operates on a straight commission basis of 5%, he receives for his services in connection with the order or orders for airplanes negotiated by him in the United Kingdom the sum of $1,000,000 in commission. Accordingly, this situation falls directly within the terms of section 2 of Article XI of the Treaty and the salesman is exempt from taxes by the United Kingdom. There is certainly no plausible reason why public entertainers, such as stage, motion-picture, or radio artists, should be excluded from the same exemption granted to the airplane salesman under Section 2 of Article XI of the Treaty.

There exists in the minds of the public generally the idea that all public entertainers are compensated on a scale comparable to the highest-paid Hollywood stars. Obviously this is as untrue as to assume that everyone in the steel industry is compensated at the rate that the president of the Bethlehem Steel Company is paid, or for that matter the head of any large industrial corporation, who is paid at the rate of between $100,000 and $250,000 per year, and often also receives a percentage of the profits. Such an executive of an industrial corporation, resident in the United States, may fly to the United Kingdom and transact business for which his compensation may be many times even that of the highest-paid public entertainers, but the head of the industrial corporation is exempt from United Kingdom taxes, assuming that he is present in the United Kingdom for no longer than an aggregate of 183 days in any taxable year.

The low-salaried entertainer in the variety field, is paid only when performing on the stage or in a night club. Out of his small salary he is required to pay for his costumes, hotel, and board, while traveling in pursuit of his profession. (Usually [illegible]nsportation is paid.) If a low-salaried public entertainer in the variety fie[illegible]ho is a resident of the United States employed by a Unit[illegible] States employer is sent by his employer to the United Kingdom to perform in the United

Kingdom, he will be subject to United Kingdom tax, only a part of which can be credited against his income tax in the United States.

The example of a low-salaried variety entertainer can be extended to any field of the entertainment industry. All concert singers are not paid large salaries—in fact usually only the leads are adequately compensated for their services. The supporting cast in any opera company are usually paid very small salaries. It is also true that musicians, whether members of bands specializing in modern music or symphony orchestras, are low-salaried employees. It is true that often, but not always, the leader of the band or the orchestra is paid an adequate salary but the members of his band or orchestra fall within the low-salaried classes, from which their expenses for instruments, uniforms, lodging, and meals are deducted.

Using the example heretofore set forth but reversing it so that an actor, a resident of the United Kingdom, performing services in the United States for or on behalf of a United Kingdom motion-picture-producing company on a loan-out arrangement similar to the example heretofore given *even though Section 3 of Article XI is not deleted will suffer no money loss.* Article XIII of the Treaty provides that the British actor will be allowed a credit against his United Kingdom taxes for all income taxes paid to the United States. Since the United Kingdom tax rate is higher than that of the United States, the actor in this example will lose no money in taxes and since it is reasonable to assume that the United Kingdom tax rate will continue to be higher than the United States income-tax rate, the British actor is not concerned with the discrimination against public entertainers except insofar as the principle is involved.

If Section 3 of Article XI remains in the Treaty the result will be loss of employment to American public entertainers who otherwise would perform their services in the United Kingdom but who are precluded from doing so because of the payment of the additional United Kingdom tax. Section 3 of Article XI acts as a tariff against the American actor, whereas, it favors the British actor, and in effect creates unfair competition for the American actor.

It, therefore, follows that if the Treaty is approved by the Senate in its present form without deleting Section 3 of Article XI, citizens of the United States who are public entertainers, such as stage, motion-picture, or radio artists, and musicians, have been unjustly discriminated against under the terms of section 3 of Article XI.

REPRESENTATIVES OF THE UNITED STATES STATE DEPARTMENT, TREASURY DEPARTMENT, AND THE BUREAU OF INTERNAL REVENUE HAVE ADVANCED NO REASONABLE EXPLANATION FOR THE INCLUSION OF SECTION 3 OF ARTICLE XI IN THE TREATY

A representative of the Artists' Managers Guild, an association of artists' managers who in turn represent public entertainers, such as motion-picture, radio, stage, and variety actors, and musicians, recently spent some time in Washington interviewing those representatives of the State Department, Treasury Department, and the Bureau of Internal Revenue who were active participants in negotiating the Treaty. The purpose of interviewing the above-mentioned representatives of the United States Government Bureaus was to attempt to discover why Section 3 of Article XI was injected into the Treaty.

There are only four reasons advanced by representatives of the United States for inclusion of Section 3 of Article XI, and they are briefly as follows:

1. That the League of Nations had agreed on a model form of bilateral convention which included such a clause. It will be shown hereafter that this is not true.
2. That the United States desired Section 3 of Article XI to be included because they wanted to collect revenue from foreign public entertainers performing in the United States.
3. That a somewhat similar clause appeared in the United States and Canadian and the United States and Swedish treaties.
4. That in the course of reaching an accord on net balance on all the provisions of a tax treaty, it is common practice to prescribe different bases for taxation, including exemptions, for different classes of taxpayers.

Let us examine the above-mentioned reasons.

1. *The League of Nations Model Bilateral Convention*

In 1943 in Mexico City a meeting of the League of Nations Fiscal Committee was held where agreement was reached between certain countries on a "Model Bilateral Convention for the Prevention of Double Taxation and Fiscal Evasion."

The United Kingdom was not represented at the conference but the United States was. At Mexico City the conferees agreed on an Article substantially similar to Article XI but *which did not include a clause similar to Section 3, Article XI of the Treaty.* There was some reference in the Protocol of the Mexico City Conference that "touring shows" would be taxable in accordance with the legislation of the country where the occupation is carried on but it was further stated *that the competent administrations of the negotiating countries may if necessary agree on special provisions relating thereto.* (Article VIII of the Protocol.) An analogy between Article VIII of the Protocol which refers to "touring shows" and Section 3 of Article XI of the Treaty is no analogy at all. There is not the remotest similarity between Article VIII of the Protocol and Section 3 of Article XI of the Treaty. Section 3 of Article XI of the Treaty deals with "an individual who is a resident of the United States," not "touring shows." The exclusion set forth in Section 3 of Article XI from the exemption set forth in Section 2 thereof still deals with "individuals" (who usually are citizens of the United States) and as such, public entertainers are entitled to the same exemption and protection accorded all other individuals resident in the United States.

2. *The United States Desires to Collect Revenue From Foreign Public Entertainers Performing in the United States*

Certain representatives of the Bureau of Internal Revenue further stated that the United States had in mind acquiring revenue from public entertainers who were residents of the United Kingdom performing services in the United States. It is indeed strange that the United States should wish to receive an infinitesimal amount of revenue from British entertainers performing services in this country at the cost of being unjustifiably discriminatory against the citizens of the United States in "show business." It is believed that the United States will not obtain sufficient revenue from the application of Section 3 of Article XI as it is now written to justify in the slightest stigmatizing public entertainers as a class.

The income-tax rate is exceedingly high at the present moment and therefore the successful public entertainer who is compensated for his services at a very high salary remits to the United States a considerable sum of money in taxes. That even the successful actor should be discriminated against is unthinkable and contrary to the fundamental principle of the American idea of fair play. Since the high-salaried public entertainer is the exception rather than the rule, the low-salaried entertainer, in being discriminated against, is the one who, least of all, can afford it.

In the motion-picture industry out of an approximate total of 8,000 actors 150 earn over $50,000 per year; 250 earn between $15,000 and $50,000 per year, and all the rest earn less than $15,000 per year, the great bulk of the latter class averaging less than $5,000 per year. In the variety field, the number of actors is greater and the average earnings are much lower than in the motion-picture industry. It can only be said that the amount which would be received by the United States from British actors performing their services in the United States for a United Kingdom employer and remaining in the United States for less than an aggregate of 183 days during any taxable year will be infinitesimal.

The United Kingdom has recently completed negotiations with the United States for a loan which is considerably in excess of four billion dollars. The matter of the approval of this loan will shortly come before the Senate. The American actor performing his services in the United Kingdom for a United States employer is penalized by paying to the United Kingdom an amount in taxes in excess of the amount he would pay to the United States if he had performed such services here. The American actor is therefore in the anomalous position of belonging to the only class of citizens of the United States (with the exception of athletes) who through payment of his United States income taxes contributes to the British loan (assuming that it is approved by the United States) and in addition pays taxes to the United Kingdom.

5. A Clause Similar to Section XI of the Treaty Appears in the Tax Treaties Between the United States and Canada and Between the United States and Sweden

A substantially similar clause does appear in the Swedish and Canadian treaties with the United States dealing with avoidance of double taxation. The fact that such a clause appears in the above mentioned treaties, however, is further indication of the unjust discrimination against public entertainers as a class. The argument [illegible] the clause should remain in the Treaty with the United King-

dom because of two previous mistakes is fallacious as certainly two previous mistakes is no precedent to continue making the same unjust error.

4. In the Course of Negotiating Provisions for a Tax Treaty it Is Common Practice to Prescribe Different Bases for Taxation, Including Exemption, for Different Classes of Taxpayers

As a general rule it may be true that it is common practice to prescribe different bases for taxation, including exemption, for different classes of taxpayers. It is certainly not common practice to make a distinction between various classes of citizens of the United States (which would be included under the classification of individuals resident in the United States) in our tax laws. In certain cases it is recognized that classes of citizens must have certain *exemptions* under the tax laws or great hardships would result. In the instant case, however, the United States has not given an exemption to public entertainers but has given an exemption to every other class of citizens of the United States *except public entertainers;* in other words, instead of granting an exemption, public entertainers are discriminated against under Section 3 of Article XI of the Treaty.

SECRECY OF NEGOTIATIONS OF TREATY AND INADEQUACY OF NOTICE OF HEARINGS BEFORE SUBCOMMITTEE OF COMMITTEE ON FOREIGN RELATIONS

The hearings before the Subcommittee of the Senate Foreign Relations Committee were held May 23 and June 13, 1945, at which time the United Nations Conference was in session in San Francisco. The testimony shows that there was an objection by one of the witnesses to the procedure followed in negotiation of all tax conventions (and in particular, the negotiation of the instant Treaty was questioned), on the grounds that all of the negotiations are held in secret, therefore, no one other than the representatives of the two governments had any opportunity to be heard prior to the closing of the negotiations.

One of the witnesses for the United States government, a representative of the Bureau of Internal Revenue, Mr. Eldon P. King, stated that there had been a press release simply giving notice to the public that the United States was undertaking to negotiate with the United Kingdom a treaty for the avoidance of double taxation. Both Senator Lucas and Senator White questioned Mr. King as to why the negotiations were conducted in secret. (See pages 63 and 64 of the transcript of the hearings before the Subcommittee of the Committee on Foreign Relations.) Mr. King replied to the effect that the executive branch of the government had always been very careful to have regard for senatorial secrecy in matters of treaties until the treaties arrive in the Senate and are then made public. He further stated that the foreign country involved has invariably insisted upon secrecy until subsequent to signature of the treaty by both countries.

Excluding the prepared written statements, the transcript of the testimony given by the witnesses covers approximately 36 printed pages, 9" x 6". Two of the five witnesses were representatives of the United States Government, Mr. Eldon P. King for the Bureau of Internal Revenue, and Mr. Colin F. Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation. One of the other three witnesses, Mitchell V. Carroll, Special Counsel for the Tax Committee, National Foreign Trade Council, Inc., was formerly special counsel for the United States Treasury, and attended the conference in Mexico City in 1943 where various powers including the United States negotiated and agreed on the Model Bilateral Convention for the Prevention of Double Taxation and Fiscal Evasion.

Nowhere in the testimony or in any of the prepared written statements is any mention made of Section 3 of Article XI by way of explanation or criticism.

If "show business" representing the public entertainers had received any notice or had seen in the papers any indication that the Treaty contained such a clause as Section 3 of Article XI the vigorous protest herein made would have been made at the hearings held in the summer of 1945 with appropriate statements and testimony by competent witnesses. The Artists' Managers Guild and the Screen Actors Guild received a copy of the Treaty and saw for the first time the provisions of Article XI thereof on or about the second week in November 1945.

Since "show business" was not represented at the hearings of the Subcommittee and was not consulted during the negotiations, it is respectfully requested that appropriate action be taken to delete Section 3 of Article XI of the Treaty and place public entertainers in the same category as all other citizens of the United States.

THE CONTRIBUTION OF THE PUBLIC ENTERTAINER TO THE WAR EFFORT EXCLUDING THOSE MEMBERS OF THE PROFESSION WHO ENTERED THE ARMED FORCES

Commencing early in the spring of 1941, after the Selective Service Act had been passed by Congress and before Pearl Harbor, "show business" of America, being the entire entertainment industry of actors and actresses in every field, motion picture, radio, stage, night clubs and variety, and musicians, without any request from the United States Government formed what later became the Hollywood Victory Committee. Actors voluntarily gave their services to entertain draftees in camps during the year 1941, and the traveling and living expenses during the initial stages of the Hollywood Victory Committee were paid for by the Association of Motion Picture Producers and the Artists' Managers Guild jointly, and in some cases were paid for by the actors themselves. *No compensation was given prominent actors either before Pearl Harbor or during the war for their services rendered in entertaining the members of the armed forces.*

After Pearl Harbor, USO-Camp Shows, Inc., was organized, and the greatest vaudeville circuit that the world has ever known came into being. Certain of the small variety actors were compensated on a reduced scale for performing their services in the camps and hospitals in the United States, and throughout the world on the battle fronts of Europe and in the Pacific wherever American servicemen were gathered, but still the big-name entertainers, such as Jack Benny, Bob Hope, Bing Crosby, Joe E. Brown, Dinah Shore, Jane Froman, Gypsy Markoff, Frances Langford, and hundreds of others, gladly, willingly, and voluntarily gave their services without thought of compensation as their contribution to the war effort. Several of them gave their lives, among them Carole Lombard; some of them were seriously injured, among them Jane Froman. These people do not deserve the unjust discrimination against members of their profession by being excluded from the exemption granted to all other residents of the United States, who would be governed by the terms of Section 2 of Article XI of the Treaty. That they are justified in having their interests safeguarded just the same as other citizens by their own government is patently apparent when consideration is given to their great voluntary contribution to the war effort as being but one of the many things that should be taken into consideration in this connection.

With full recognition of the right of the Congress under the Constitution of the United States to pass laws affecting certain properly classified portions of the public, there is nothing inherent in the profession of public entertainer to justify tax discrimination either by legislation or Treaty against this profession alone.

The Constitution does not specifically mention the public entertainer as being a class of citizen who should not be discriminated against, but certainly the spirit, if not the letter of the Constitution is being violated by the terms of Section 3 of Article XI of the Treaty. It is not intended herein to raise the question as to whether a treaty between the United States and the United Kingdom can change the letter or spirit of the Constitution of the United States, but it is a matter of deep consideration for the members of the Senate to say whether Section 3 of Article XI as now written does not completely and totally ignore what the framers of the Constitution meant when they took great pains to protect the interests of all citizens of the United States against class discrimination.

IN CONCLUSION

There is no member of the Senate, past, present, or future, who would not rise in righteous indignation were Section 3 of Article XI of the Treaty to read as follows:

> "3. The provisions of this article shall not apply to the compensation, profits, emoluments, or other remuneration of persons resident or domiciled in the State of ....."

and each Senator may insert the name of his own state in the above blank space. If the Senator did not object to such unjust discrimination on behalf of the residents of the state which he represents he would be subject to the severest criticism by his constituents who elected him, and rightly so. The members of the acting profession feel the same as the constituents of any state in the United States would feel if they were unjustly discriminated against. *There are public entertainers resid[illegible] in every state in the union, not just in California, New York and Illinois.*

The Artists' [illegible]agers Guild, an association of artists' managers, and the Screen Actors Guild, a labor union representing all the actors in the motion-picture

industry, have collaborated in this brief. It is anticipated that the following labor unions representing public entertainers in the following fields will make direct representations to either the Senate or the Subcommittee of the Senate Foreign Relations Committee (assuming that the Treaty is referred back to the Subcommittee) and that such representations will concur with the views set forth in this brief:

American Federation of Radio Artists, representing all actors in the radio industry.
American Guild of Variety Artists, representing all actors in the night-club and variety field.
Actors Equity Association, representing all actors on the stage.
American Guild of Musical Artists, representing all concert artists.

With the exception of the Artists' Managers Guild, all of the foregoing, including the Screen Actors Guild, are affiliated with the Associated Actors and Artistes of America, which in turn is affiliated with the American Federation of Labor.

We respectfully request that Section 3 of Article XI be deleted from the Treaty on the grounds stated in this brief.

ARTISTS' MANAGERS GUILD,
By ADRIAN MCCALMAN,
Administrator.

SCREEN ACTORS GUILD,
By JOHN DALES, Jr.,
Executive Secretary.

Senator LUCAS. There is one thing that I noticed from this table. It would seem that the lower-income fellow is hit harder under the tax exchange than the fellow who, for instance, has a $200,000 income. England taxes the $200,000 man in the amount of $35,000, while the maximum United States credit would be $32,230—a difference of only $3,000.

Mr. MCCALMAN. That is correct.

Senator LUCAS. So it would not make much difference to him, on that basis, but it might make a good deal of difference to the little fellow who was struggling to get along.

Are there any other statements?

Mr. KING. There is one more point, Senator.

Senator LUCAS. All right, Mr. King; proceed.

Mr. KING. This, I think, probably should go into the record. Mr. McCalman and others have assumed that Britain would tax the American actor working for the American concern, who is loaned or leased to the British concern. Now, it is our understanding that this is a very doubtful point. The British reserve the right to examine the contracts in each case and consider all the facts, and as we read the British decisions, there may be many instances where the American actor will not be taxed at all under the British law. If so, of course, there is no double taxation, no credit involved; and from another angle he is better off than the British actor who comes here, because we will tax him, regardless of where his contract is made or for whom he works.

With further reference to this point, I would like to ask these gentlemen if they know of any specific instances where Britain has taxed the actors under the 5- or 7-year contracts with American companies, who have been loaned to British companies?

Mr. DALES. Could we put it this way, Mr. King? Do you know of any instances where they have not?

Mr. KING. I have no way of knowing one way or the other.

Mr. DALES. I know of Americans be[illegible] taxed, but I do not know what their set-up was. I know Claude [illegible]ins was taxed by England.

I do not know what his contractual set-up was. We have not had such opportunity. I certainly know of no case where one was not taxed.

Mr. McCALMAN. That is about the only case we know of in the last 5 or 6 years.

Mr. DALES. Mr. Abel was taxed when he went to England, but of course he was working I think for an English producer.

Mr. ABEL. Yes. You are speaking of an American contract actor, working for an American contractor, in England?

Mr. DALES. Either way.

Mr. ABEL. But this act penalizes the contract player—the man who is under contract to an American company.

Mr. DALES. That raises this point, Mr. King, if I may say so. It is interesting that, in view of the fact that this language in the treaty is so clear, that—

> An individual who is a resident of the United States shall be exempt from United Kingdom tax upon profits, emoluments * * * in respect of personal * * * services—

if there has not been a tax, there certainly is going to be—isn't it? It says, "We will exempt everybody from United Kingdom tax, except the actor."

Mr. KING. No; I do not believe your thought is correct, there. The treaty in referring to an exemption or a credit does not mean that in all instances there has been a tax. You turn to the laws to find whether there has been a tax.

Mr. DALES. That is right.

Mr. KING. If there has been, then the credit comes into play. This assumes, however, that there is a tax to start with.

Mr. McCALMAN. Your original statement was that this is a controversial point, as to whether or not an actor, under the circumstances set forth in section (2) of article XI is taxed by the United Kingdom.

Mr. KING. That is right.

Mr. McCALMAN. You can certainly resolve that controversy by deleting section (3), and if there is no tax in England, there is no reason for discriminating against the American actor, because it leaves the door wide open for the United Kingdom to say, "Well, all right, our British subject, going on a loan-out from a British company to an American company, is taxed by the United States—we will reciprocate." I mean, isn't that mostly true of international tax laws—reciprocity? So they will pass a law taxing American actors if it is not clear at this point.

Mr. KING. No; I think that goes too far. There are many instances where countries do not change their law, after a treaty, to fit the law of the other country.

Mr. McCALMAN. I cannot answer for England. I do not know whether you could.

Mr. KING. I do not want to press the point too far, but in order for us to run it down, we would have to examine numerous cases in the Bureau; but you, being in the profession, I thought might have knowledge of such cases.

Mr. DALES. No.

Senator LUCAS. We do not want you to go that far. We do not want you to run down all the law; we haven't got time for that. Now, are there any other questions?

(Mr. King presented for the record the following table, showing the operation of the United States credit to the American actor who is taxed in Great Britain:)

Assuming, without admitting, that the United Kingdom imposes a tax on the earnings of the United States actor present in the United Kingdom the effect of the credit for United Kingdom tax may be seen from the following table:

Assumed total annual income	United States tax	3 months in United Kingdom		4 months in United Kingdom		5 months in United Kingdom	
		United Kingdom tax	Maximum United States credit	United Kingdom tax	Maximum United States credit	United Kingdom tax	Maximum United States credit
$20,000	$3,200	2,200	1,320	3,000	1,733	4,167	2,167
$40,000	13,110	6,700	3,778	8,644	5,017	8,140	6,278
$60,000	26,820	7,724	5,705	10,015	8,910	14,721	11,175
$80,000	39,740	11,016	9,916	16,012	13,240	21,215	16,575
$100,000	53,250	14,724	13,703	21,248	17,970	28,318	22,463
$120,000	68,210	18,000	17,072	26,718	22,713	35,000	28,412
$140,000	83,340	22,624	20,835	32,740	27,750	43,365	34,725
$160,000	98,470	26,744	24,518	38,640	32,823	51,190	41,025
$200,000	128,920	35,000	32,230	51,190	42,973	67,000	53,717

NOTE 1.—The conversion rate employed is $4 to the pound sterling.

NOTE 2.—The United Kingdom tax is that computed by the British revenue converted into dollars.

NOTE 3.—In computing United States tax 2 credits are employed (married person no dependents).

NOTE 4.—In computing United States tax, deductions of 15 percent of gross are allowed for contributions, taxes, interest, bad debts, losses. Statistics indicate this is a liberal allowance, tending to decrease the amount of the credit.

It will be seen from the schedule that the actor (if he should be subject to United Kingdom law) may proceed to the United Kingdom, remain therein four months in the pursuit of his employment for his United States employer and receive as a credit against his United States tax from 30 to 50 percent of his United Kingdom tax. In reaching these percentages it will be observed that there are assumed aggregate deductions of 15 percent of gross income. In any case in which the net income (other than salary or in which the deductions fall below 15 percent of gross income the amount of credit allowed increases.

Senator Lucas. I have requested Mr. Stam to submit a further statement he desires to make before the committee as a part of this report upon the question which is in issue—not the refugee question, but the question of the deletion of paragraph (3) of article XI.

(The statement referred to, subsequently supplied by Mr. Stam, is as follows:)

STATEMENT OF COLIN F. STAM, CHIEF OF STAFF, JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

Under article XI of the Convention, income from personal services is exempt from the United States tax (*a*) if the British resident performing such services is in the United States for a period not over 183 days during the year and (*b*) the services are performed for a resident of the United Kingdom. Similarly, income from personal services performed by a resident of the United States is exempt from United Kingdom tax (a) if the person performing them is in the United Kingdom not over 183 days during the year and (*b*) the services are performed for a resident of the United States. However, the exemption granted by the article does not apply to the compensation of public entertainers such as stage, motion picture or radio artists, musicians, or athletes. Because of the fact that public entertainers are not given the same exemption, it is claimed by representatives of the motion-picture industry and others, that the convention is discriminatory and should be amended so that public entertainers may be treated like other persons performing services in the United Kingdom or in the United States, as the case may be.

The public entertainers exception stems from the Revenue Act of 1936 and has been applied not only in the British convention, but also in conventions with Sweden and Canada.

Under the Revenue Act of 1936, personal services performed by a nonresident alien individual, temporarily present in the United States, for a period not exceeding a total of 90 days durnig the taxable year, and whose compensation for such services did not exceed in the aggregate $3,000, was exempt from the United States income tax. A similar provision is contained in the current Internal Revenue Code, section 211 (b). The necessity for adopting such a provision in our Internal Revenue Code was explained by Mr. Kent, of the Treasury Department, in a statement before the Senate Finance Committee when the Revenue Act of 1936 was under consideration. Mr. Kent's statement as to this point is as follows:

"Mr. KENT. There is a provision in the present law, section 19, defining income from sources within the United States, which provides that compensation for labor or services performed within the United States shall be deemed income from sources within the United States. I think some of the cases to which reference has been made are simply absurd. I think it is really beneath the dignity of this Government to hold a commercial representative who has been here negotiating commercial contracts for 3 or 4 weeks, up at the port in order to squeeze a few dollars out of him, but our agents do it. We cannot very well tell them in Washington that they are violating the law in doing so, and it is a very difficult situation to deal with.

"Senator KING. In a case I referred to, the man was here 2 weeks, and they asked him to make a return and pay, and he was here trying to find a market for our goods. He wanted to buy goods here, and he wanted to sell goods in return.

"Mr. KENT. And on the other hand, one thing that makes the situation rather difficult to deal with is this: You may have some English pugilist or German pugilist or theatrical star coming over here and being here for 2 or 3 months and making $100,000 or $200,000 out of their activities in this coutry, and the feeling there is that we ought to get some tax out of it. So it is rather difficult to frame an amendment even which will draw the line of distinction and let out the cases that you want to exclude without letting out some that you want to include."

The report of the Finance Committee, under the revenue bill of 1936, also sets forth the necessity for such a provision in the following language:

"One other change in the taxation of nonresident aliens is recommended by your committee in the form of an amendment to section 119 (a) (3) of the House bill. This amendment would operate to exclude from the definition of income from sources within the United States compensation received by a nonresident alien individual for labor or services performed in the United States under an employment or contract with a nonresident alien individual or a foreign partnership or corporation, provided such services are rendered by such nonresident alien individual while temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and that the aggregate compensation for such services does not exceed $3,000. The purpose of this amendment is to permit residents of other countries to make brief visits to the United States for business purposes, such as the buying and selling of goods, without being subject, before leaving the country, to a demand for payment of tax on their compensation during the period of their stay here. Numerous cases of this character arising under the present law have created irritation and ill will quite disproportionate to the slight revenue involved. The limitations contained in the amendment are, it is believed, adequately drawn to prevent any serious abuse of the exemption. This change is consistent in purpose with the amendment to section 211 (b) which the committee has recommended."

A study of the legislative history indicates that the $3,000 limitation was inserted so that foreign pugilists or theatrical stars conducting performances in this country for 2 or 3 months and receiving considerable remuneration for their services would still be subject to the United States tax. The convention, Article XI, is not incorporating the $3,000 limit, would completely exempt British actors, athletes, and other public entertainers from the United States tax for services performed in the United States within the prescribed 183 days if such services were performed for a British employer.

Accordingly, unless the convention did not exclude from the benefits of Article XI compensation of public entertainers, the compensation of British pugilists or theatrical stars performing services in this country under a contract for a British resident made in Great Britain would be completely exempt from the United States tax. Therefore, aside from the question of whether any change in the Convention at this time would unduly delay its adoption pending further negotiation, there remains the question as to whether the committee believes a United

States tax should be collected on services performed by British public entertainers in this country.

An examination of the British statutes and decisions raises considerable doubt as to whether an American actor performing services in the United Kingdom for a period of less than 6 months will be subject to the British income tax. If he is merely exercising an employment in Great Britain as distinguished from a profession, the British law does not appear to reach him where the contract was made in the United States, and payment of the compensation is made there.

The American actor may be able to establish that he is not carrying on a profession in the United Kingdom but merely exercising an employment there. The British court in the case of *Davies* v. *Braithwaite* (18 TC 198 (1928-1929)) made the following distinction between the carrying on of a profession and the exercise of an employment:

"But I would go further than that, and what I say is that it seems to me that where one finds a method of earning a livelihood which does not contemplate the obtaining of a post and staying in it, but essentially contemplates a series of engagements and moving from one to another—and in the case of an actor's or actress' life it certainly involves going from one to the other and not going on playing one part for the rest of his or her life, but in obtaining first one engagement and then another, and a whole series of them—then each of these engagements could not be considered an employment, but is a mere engagement in the course of exercising a profession, and every profession and every trade does involve the making of successive engagements and successive contracts and in one sense of the word, employments. That is the line which I draw on that principle, rightly or wrongly."

In *Bennet* v. *Marshall* (22 T. C. (B 73) (1938)) was involved the case of an employee or officer of the National Cash Register Co. who, under his contract of employment made in the United States, was a sales manager for that company throughout the world, except the United States and Canada. Marshall was a resident of the United Kingdom for many years prior to the years involved (1934 and 1935); his salary was deposited to his credit in a Canadian bank against which deposit he drew from time to time to meet his living and other expenses in England, with the result that he drew approximately one-half his salary. The question involved was whether Marshall was liable to United Kingdom tax upon his entire salary or merely upon that portion of his salary which he brought into the United Kingdom. The English courts uniformally held that Marshall received income from an employment and hence under English law was subject to United Kingdom tax only upon that portion of his salary which he brought into the United Kingdom. The principle upon which the court proceeded is expressed as follows:

"The House of Lords, as it seems to me, in *Pickles* v. *Foulsham* (9 T. C. 261) have definitely decided that, in the case of an employment, the locality of the source of income is not the place where the activities of the employee are exercised but the place either where the contract for payment is deemed to have a locality or where the payments for the employment are made, which may mean the same thing."

Thus, it was held that even a resident of the United Kingdom acting upon a contract of employment executed abroad where the remuneration is also paid abroad is liable for United Kingdom tax only on that portion of such remuneration which is brought into the United Kingdom.

It would therefore appear with reasonable assurance that a United States actor, an employee under a long-term contract of employment with an American producing company, who is temporarily present in the United Kingdom, either on loan to a British producing company or on behalf of his American employer for the purpose of making a picture or portion of a picture in the United Kingdom, is exercising an employment and thus if his salary is paid in the United States and not reduced to possession in the United Kingdom, he would be exempt from United Kingdom tax on such remuneration.

It should also be noted that the principle of *Bennet* v. *Marshall*, supra, is clearly applicable to the case of a resident of the United States who (*a*) goes to the United Kingdom for a short period, (*b*) sells there merchandise for his United States employer, and (*c*) derives, say, $100,000 commission for such sale, such commission being deposited to his account in the United States. In such case the United Kingdom under its revenue laws would not impose its tax on such income, contrary to the impression created elsewhere in the record of this hearing. Independently, therefore, of the provisions of the convention such commission would be exempt from United Kingdom tax.

It would therefore appear from the state of English law as set forth in the cited decisions that there would likely be no English tax and to that extent there would be no reduction of United States revenue due to the credits for United Kingdom tax which would follow had the English tax been imposed upon the English earnings of United States actors temporarily present in the United Kingdom.

Permission was granted by Senator Lucas to Adrian McCalman and John Dales, Jr. to reply to Mr. Stam's statement.

(The statement referred to, subsequently supplied by Adrian McCalman and John Dales, Jr., is as follows:)

STATEMENT FOR THE RECORD IN THE SENATE FOREIGN RELATIONS SUBCOMMITTEE HEARING OF WEDNESDAY, APRIL 17, 1946

Pursuant to permission granted by Senator Scott W. Lucas, John Dales, Jr., and Adrian McCalman hereby file the following statement in answer to any material submitted in the above hearing by Mr. Colin Stam.

Mr. Stam has attempted to trace the history of the excepting of public entertainers from the benefits granted to other employees generally to the Revenue Act of 1936. In a sense our entire case rests upon such reasoning by Mr. Stam and Mr. King of the Internal Revenue Department. As Mr. Dales stated to Mr. King, actors had no objection to the fact, if it is a fact, that the Revenue Act of 1936 may have affected them more severely than it did other classes of employees, because if it did so, it did it by indirection. Actors were not specifically excepted from the benefits granted to others under this revenue act. The act exempted all employees—nonresident aliens temporarily present in the United States for a period not exceeding 90 days whose incomes did not exceed $3,000—from United States income tax. According to testimony adduced prior to the passage of said revenue act, the purpose of such a formula was to except from the exemption of taxes the cases of large income earners, for example, pugilists and theatrical stars. That may be. There was no evidence then or ever introduced to show that, as a matter of fact, more high-income public entertainers were affected than other high-income earners such as salesmen or executives. In any event, the formula set forth in said revenue act acted equally upon all high-income earners whatever their business or profession. Had said act blatantly named public entertainers as the sole group to be excepted from the benefits of tax exemption, then it would undoubtedly have been invalid as unjustifiable class legislation. To put into a treaty language which if put into a law would render that law unconstitutional and invalid is a precedent which is dangerous, unjustified, and, above all, unnecessary. The formula used in the 1936 Revenue Act was used in substantially the same language in other tax treaties. The fact that the Internal Revenue Department chooses to think that more actors will be affected thereby than other employees, does not make such formula objectionable to actors.

We are informed by the representatives of the Internal Revenue Department that they now prefer to specifically exclude public entertainers by name rather than to use the formula above discussed because even if they miss collecting tax on a high-income-earning foreign director, executive, or salesman, these persons are here in the interests of international intercourse and stimulate international trade. When asked if the same is not true with regard to the interchange of public entertainers to the stimulation of international trade in the motion-picture industry (which is after all just a manufacturing business) and in the other public-entertainment fields, they simply answer that there may some day be another Firpb or Georges Carpentier and they want to tax such person if and when he comes to this country. We ask why, to catch a high-income earner such as the next greater foreign boxer, must a professional line be drawn covering only public entertainers, whether large- or small-income earners. Would it not be more logical to draw a line covering all high-income earners regardless of business or profession? At this point we are reminded that Senator Lucas asked if there were any figures available to throw any light on the amount of talent interchange between England and the United States. We have been able to find no accurate count, but every booking agency will testify that the ratio of American actors going to the United Kingdom as against British actors brought to the United States is almost 20 to 1. While there may be many factors contributing to this one-sided interchange, perhaps the best reason is simply that the English public has proved much more receptive to American actors and forms of entertainment than the American public has to the English entertainers.

We understand that the Bureau of Internal Revenue has run a test check on the amount of income earned by aliens in the stock market and that the findings of the Department will enable this subcommittee to arrive at a conclusion regarding the criticism leveled at article XIV of the treaty. It would be well if a similar check could be made with reference to the probable tax income to this country from visiting English public entertainers who would be tax-exempt under the limited circumstances of section 1 of article XI of the treaty were they not excepted therefrom by section 3. We are certain that such a check would prove this expected taxable income to be many times less than that earned by the aliens above referred to, and in consequence even less of a problem.

Representatives of the Internal Revenue Department, next, have chosen to term our objection to section 1 of article XI as "sentimental" upon the grounds that they do not that British law authorizes the taxation of American performers who go to England for less than 6 months for American producers. They will not state that England does not tax such performers but rather put in the form that, if taxes, the American entertainer can take the matter to court successfully under their interpretation of British law. They maintain, then, that the American actor actually has the same benefits in England which are given to all other classes of employees under section 2 of article XI, irrespective of the apparent avoidance of this by section 3. This is just not the English law and the very cases cited in Mr. Stam's additional statement prove our point.

In the Braithwaite case, although there is some dicta which sounds as though the court is also doubtful as to whether England can tax an American performer under the circumstances of that case, the judgment of the court finally ends by taxing Mrs. Braithwaite, the question being resolved by other factors not concerned in our case.

In the Marshall case, it is true that Marshall escaped tax on moneys never reduced to possession in England. We ask the Internal Revenue Department representatives where in Article XI they find this additional requirement; that to escape taxation by Great Britain the money must not be received in England.

In other words, if the Internal Revenue representatives have concluded that even if actors are excluded from the benefits of article XI, they nevertheless actually have the same benefits by reason of the state of English tax laws, that conclusion is patently false. Under article XI an employee working in England less than 6 months for an American employer is exempt from British tax, even if he receives his salary or remuneration in the United Kingdom. Whereas under the general tax laws which would govern actors, even if the Bureau is right as to the effect of that law, actors would be taxed on any salary or remuneration they received within the United Kingdom and it is no answer to say that they could arrange to be paid in the United States. That might constitute evasion. It certainly adds complications and requires the actor to take risks to which there is no need to subject him. One should not forget that inasmuch as this law applies to all actors regardless of their incomes, they will in the main not be able to afford themselves the advice of reliable tax experts.

Even had our case been one of sentiment, it would be worthy of the full consideration of the Senate. Who knows what the tax laws of Britain will be tomorrow? In fact, if, as we understand it, treaties override laws, who knows what the British tax laws will actually be on the day the treaty is signed, for article XI, sections 2 and 3 then become British law. It would appear that actors at that moment are certainly adversely affected by the plain invitation and perhaps the plain requirement that by the terms of this treaty actors, not being exempted under section 2, shall be taxed by the United Kingdom.

For all of the reasons stated in this hearing, the language of section 3 of article XI should be deleted from the treaty.

Respectfully submitted.

SCREEN ACTORS GUILD, INC.,
By JOHN DALES, JR.

ARTISTS MANAGERS GUILD,
By ADRIAN MCCALMAN.

TAXATION OF REFUGEES

Senator LUCAS. You wanted to discuss one question with respect to refugees, that came up in these previous hearings, which does not concern the question which is in controversy before the committee.

Mr. MCCALMAN. Thank you, Senator Lucas, very much.

Mr. DALES. Do you want to excuse us?

Senator LUCAS. You gentlemen may be excused, unless you want to hear something about taxation of refugees. You might be able to help us a little on that.

Mr. MCCALMAN. We might have some refugee actors over here. I understand that we have some.

Senator LUCAS. Incidentally, that is of more concern to a lot of folks than protecting the actor here from a little double taxation.

Mr. KING. Since our principal report was completed, in February 1946, we have continued with the investigation, and I also desire to submit a supplemental report modifying some of the figures used in the February report. However, by a comparison of the two, it will be noted that in all essential particulars the recent report does not affect the prior report.

Senator LUCAS. The question in the previous hearing was raised by some members of the committee with respect to the possibility of the taxation of certain refugees that were in this country for a short while, making a lot of money, so the story goes, and at the time we had these hearings, the Treasury Department did not have a full and complete report, but promised the committee that as soon as the investigation was completed they would make a report back to the committee. It seems to me that this is an appropriate time for the Treasury Department to make such report; so proceed, Mr. King. I say this with the understanding that the report is now complete.

Mr. KING. Following the last meeting on the treaty with the United Kingdom, and because of questions concerning refugee aliens, which had also been raised before the Ways and Means Committee, the Bureau undertook an investigation of the problem. The investigation was quite comprehensive. I think I should just attempt to give a brief summary.

Senator LUCAS. Yes; just brief the high lights, then place your manuscript in the record, because I am scheduled to leave here in about 5 minutes.

Mr. KING. I might even suggest this, that maybe it would be better if I just handed this in instead of summarizing.

Senator LUCAS. Have you got a complete report of it?

Mr. KING. Yes.

Senator LUCAS. Well, I think that is perhaps preferable.

Mr. KING. I think so.

Senator LUCAS. Without objection, it may be so ordered.

(The memorandum concerning investigation of alien taxation with the supplemental report submitted for the record by Mr. King, is as follows:)

MEMORANDUM CONCERNING INVESTIGATION OF ALIEN TAXATION

ORIGIN OF PROBLEM

Beginning about May 1945 there appeared in the press a series of articles questioning the sufficiency of the existing income-tax law as applied to aliens who were physically present in the United States. The articles referred to "refugee stock traders" or "guest speculators" and the like who as war refugees in the United States were reaping allegedly tax-free profits in this country, especially in their transactions on domestic stock and commodity exchanges. Some writers suggested that such profits might be as high as $500,000,000 on which the minimum tax would be about $200,000,000. In connection with a legislative measure pending before the Ways and Means Committee and an income-tax convention

pending before the Senate Foreign Relations Committee, consideration was given to possible enabling legislation but action was suspended pending further check concerning the adequacy of existing law.

APPLICABLE STATUTORY PROVISIONS

There are outlined below the provisions of existing law, including tax conventions, which are the subject of the present controversy.

For Federal income-tax purposes aliens are classified into resident and nonresident aliens and the latter are subclassified as between those (*a*) not engaged in trade or business in the United States and (*b*) those engaged in trade or business therein. An alien resident in the United States is, like the citizen of the United States, taxed on his income from all sources, including his capital transactions. However, in the operation of the credit provisions contained in section 131 of the Internal Revenue Code he may be denied credits for foreign taxes paid which are granted to the citizen.

The nonresident alien not engaged in trade or business in the United States is taxed on all his fixed or determinable annual or periodical income from sources within the United States such as dividends, interest, rents, and royalties, but is exempt from tax on any gains from his transactions in stocks, securities, or commodities through a United States resident broker, commission agent, or custodian. The exemption thus granted to aliens in this category and on this class of transactions takes account, inter alia, of the rate of tax (imposed on a gross basis) on such periodical items of income and such administrative questions as the impracticability of determining and enforcing a tax against such aliens incident to their transactions clearing through our domestic exchanges. House Report No. 2475 and Senate Report No. 2156 on the revenue bill of 1936 recognize the collection difficulties involved in this type of case.

The system of levying a gross tax on items of fixed and periodical income, with accompanying provisions for collection at source, has proven very successful since its adoption in 1936, not only from an administrative but also from a revenue point of view. The tax collected in this class of cases in 1943, the latest year for which complete statistics are available, was about $50,000,000 which exceeds by many times collections from such class of taxpayers under previous principles of taxation.

Under existing statutory provisions the nonresident alien is not subject to tax on capital gains merely by reason of his transactions in stocks, securities, or commodities through a resident broker, commission agent or custodian, but he is subject to tax on such gains if he is otherwise engaged in trade or business in the United States and most any sort of activity in this respect, including the performance of personal services within the United States at any time during the taxable year, constitutes engaging in trade or business. However, it should be observed that with respect to countries with which we have income-tax conventions (Canada, France, and Sweden), this particular phase of alien taxation is modified to provide that residents of those countries (other than United States citizens) are not subject to tax on capital gains unless they have a permanent establishment in the United States. This forms a part of the permanent establishment base used elsewhere in the conventions, and the base so employed with those countries has been made a part of the pending convention with the United Kingdom. The adoption of the permanent establishment principle has been found in the course of the investigation referred to below to have little effect on cases involving nationals of Canada, France, Sweden, or the United Kingdom. Thus out of 12 cases of British subjects involving potential deficiencies of about $60,000 none is affected by the permanent establishment principle. Also in the case of eight French citizens involving proposed deficiencies of about $500,000 the outcome of only one deficiency of about $250 seems to be dependent on whether the individual had a permanent establishment in the United States. No cases of Canadian or Swedish nationals involving this principle have been discovered.

SCOPE OF INVESTIGATION

The investigation referred to above as to the adequacy of existing law was opened by the issuance of Commissioner's Mimeograph No. 5883, dated June 27, 1945, for the information of the public and Bureau personnel and contained a careful analysis of the operation of existing law. The Commissioner accompanied such mimeograph by a press release calling attention to the narrow scope of the exemption granted to nonresident aliens deriving income from United States

sources and directing that close scrutiny be made of all claims for exemption. Noncitizens were also asked to consult with appropriate Bureau officials in order to have their tax status clarified and their attention was called to the provisions of existing law which require departing aliens to obtain tax clearance before departure. As a part of the general assistance and investigative plan, intended to assure fair and proper treatment under existing law and to provide data which might afford a basis for legislative or administrative improvements, a questionnaire (Form 1044) was prepared and issued in order to elicit all pertinent facts bearing on the question of proper classification of noncitizens for taxation purposes. The form did not ask merely that the noncitizen claiming exemption state certain conclusions of law or fact respecting his status but was of searching character intended to bring out all his activities from which the Bureau could form its own conclusions.

Although the investigation was of comprehensive scope and one of continuing application, activities were centered largely on certain groups in which the Bureau had the most immediate interest. Thus, there were first brought under investigation those aliens who brought with them or otherwise transferred property in considerable amounts into the United States. With the cooperation of officials of the New York Stock and Commodity Exchanges, Bureau agents examined all accounts in such exchange houses of the above and any other groups who had engaged in transactions on those exchanges. In making such check there were set aside all accounts of noncitizens who were subclassified as between resident and nonresident aliens. Altogether in excess of 700,000 accounts were examined and from these about 15,000 accounts of noncitizens were located. Similarly, a check was made of all custody, safekeeping, and investment agency accounts in the banks of the New York area and from this check a list of 5,000 noncitizen accounts was compiled. Cases were also located through standard Bureau procedure and a good many names of aliens sent in by the public or mentioned in the press were included in the Bureau's investigation. As a part of the plan it was necessary to eliminate duplications incident to one party having an account with more than one brokerage or financial house and also to transfer a good many cases from one district to another because of changes in addresses. Upon making such adjustments there remained for investigation in the New York area alone about 12,200 cases and for the country as a whole about 15,000 cases.

Satisfactory methods of cooperation having been perfected between the Bureau and the New York brokerage and banking institutions, the Bureau field offices were asked to enter into similar arrangements with such institutions in their respective territories. A similar spirit of cooperation was found to exist in such territories; in fact, the program was greatly facilitated in the New York and other areas by the publicity and public interest which it attracted.

RESULTS OF INVESTIGATION

The investigation to date has uncovered 70 cases where dispute exists as to whether the noncitizen is a nonresident or resident of the United States or whether he was engaged in trade or business within the United States. The amount of taxes proposed by the Bureau in such cases is $3,953,253 attributable to a variety of causes which are difficult to summarize. However, the two largest deficiencies amounting to about $1,500,000 and $500,000, respectively, are proposed against former citizens who, after renouncing their citizenship, have been in the United States since the early days of the war. The deficiencies in these cases may be attributed almost entirely to causes other than capital transactions; 5 of the 70 cases account for about $2,900,000 of the total proposed deficiencies. Out of the 70 cases 43 involving $3,579,339 in proposed deficiencies, are situated in the New York area. These cases were located as the result of processing about 10,500 cases. Of the 10,500 aliens investigated about 80 percent were found to have filed returns on the basis of being resident in the United States or engaged in trade or business therein, thus conceding that they were subject to tax on their income from capital transactions in the United States. About 15 percent of the group of 10,500 cases were found not to merit further investigation because of the small amounts involved. About 3 percent of the remaining 5 percent are classified principally as resident aliens not required to file returns because their income was less than allowable exemptions. The balance is composed of nonresident aliens not engaged in business in the United States who were not required to file returns because their taxes had been fully satisfied at source and nonresident aliens who had filed returns reporting their taxes which had not been fully satisfied at source. Only a few of such nonresidents were found to have been in the United States during the taxable periods involved and their stays here were of very limited duration. Of the 12,200 potential noncitizen taxpayers in the

New York area about 800 have not yet been contacted and about 900 cases are still in process of audit. After giving special attention for the past several months to cases where there was delayed response to Bureau letters, it has been found that such delay was in nearly all instances due to ordinary causes, such as changes in address, so it is not anticipated that the group of 800 cases will be productive of substantial deficiencies; in fact, based on past experience, it is thought that practically all of these cases will be dropped because of the small amounts involved. Moreover, considering that all cases where contacts had been made were examined in selecting the 43 cases, representing those where deficiencies were most likely to develop, it is not believed that substantial deficiencies are likely to be uncovered in the final audit of the group of 900 cases.

Altogether it seems that the figure $3,953,253 is not likely to be increased when the 79 cases are finally adjusted. It is known that adjustments will be upward in some cases when the years 1944 and 1945 are considered but it is also known that in computing tentative taxes making up the $3,953,253 figure gross income has been used in many instances, pending ascertainment of the cost of securities and other deductible items, and that, pending further investigation as to the time the capital assets were held, tax has been computed on the basis of short-term gains. It also seems unlikely that the Government will be successful in asserting its claim of residence or engaged in business in all cases. However, even if the figure $3,953,253 were doubled to take care of the above and other contingencies, such as the discovery of new cases, it would still be quite small from a revenue point of view considering the amount of effort which has been put into the project. In this general connection, the current additional taxes being asserted as the result of audits of other cases and other investigative projects of the Bureau are now exceeding $1,000,000,000 per year.

SUMMARY OF INVESTIGATION

The claims made in the press and financial circles that aliens present in the United States were engaged in business transactions on substantial basis in this country, especially on our exchanges, seem to have been well founded but there seems to be little justification for the charge that they have attempted to avoid taxation under the provisions of existing law. On the contrary, the studies indicate that all except a comparatively small number of the aliens having any potential liability have heretofore filed tax returns on the basis of being resident in the United States or engaged in trade or business therein, thereby admitting that they are subject to tax on their capital transactions in this country. As with respect to citizens, errors may be found upon audit of their returns but it is important to note that they have not tried to hide or to avoid their responsibilities under our tax laws. Moreover, a test check made of the more important returns filed indicates that the percentage of accuracy and error is comparable to that found in the returns of citizens. Even in the 79 cases many of the aliens had filed returns on a nonresident basis.

However, aside from the immediate results of the investigation, reflected primarily in the 79 cases, there are certain over-all considerations which should be mentioned. Although such immediate results have been quite negligible from a revenue point of view, the matter of alien taxation becomes active every few years and it is believed that the statistics gathered will be found to be of substantial benefit for future legislative and administrative purposes. Also, upon considering the publicity given to the investigation and the thoroughness with which the alien field was combed, it is believed that the program is entitled to credit for certain indirect benefits looking toward a better understanding and enforcement of taxes in the alien field.

PRIOR LEGISLATIVE CONSIDERATIONS

This subject is reflected primarily in H. R. 3138, May 7, 1945; the report of the Committee on Foreign Relations concerning the proposed income tax convention between the United States and the United Kingdom (executive report No. 6, July 3, 1945, 79th Cong., 1st sess.); and in the discussion between Senator McMahon and Senator Maybank on the subject of alien taxation (vol. 91, July 19, 1945, 79th Cong., 1st sess., pp. 7910-7919). The legislative changes considered were those involving (1) a statutory definition of "residence" and (2) a modification of the existing statutory definition of engaging in trade or business. In executive report No. 6 the conclusion was reached that any statutory definition of residence would be equally applicable to cases coming within the pending convention with the United Kingdom, since residence is not defined in such convention. The conclusion was also reached that although a change in the definition of what constitutes engaging in trade or business might not affect all cases coming

within such convention there were important compensating factors. In the course of discussion between Senator McMahon and Senator Maybank the former stated, in effect, that although he was first inclined to feel that the importance of the subject was such as to warrant the consideration of an amendment to existing law to define what constitutes "residence" he had since concluded that the defect was not so much a matter of statutory law as of interpretation thereof and that upon careful study of the revised rulings of the Treasury in this regard he was not prepared to say that the situation had not been taken care of. Senator McMahon also gave assurances to Senator Langer that the revised rulings of the administrative branch would be applied retroactively to cover those aliens who had been in the United States during the war period; and, it should be added, that such rulings have been so applied and their application so reflected in the above-mentioned results of the recent drive. It should also be noted that, for the reasons above stated, any interpretation of residence by the administrative or judicial branches is equally applicable to our several income-tax treaties.

Although considerable attention has heretofore been given to the legislative approach to a solution or improvement of the problem, the purpose of the present memorandum is merely to set forth the facts recently ascertained by the Bureau with respect to the taxability of income, particularly capital gains, derived from sources within the United States by refugee aliens. It is thought that further development of the subject would be somewhat premature until the interested committees of Congress have had an opportunity to consider the recent factual development of the problem.

Noncitizen taxpayers' cases assigned, New York Area Field Divisions, as of Apr. 15, 1946

	Second New York	Upper New York	Brooklyn	Total
Total letters mailed	1,401	8,317	2,658	12,636
Replies received [1]	1,414	8,208	2,658	12,280
No reply	47	309	None	356
Replies received	1,414	8,208	2,658	12,280
Transferred	16	218	100	400
Replies to be accounted for	1,398	7,990	2,492	11,880
Replies to be accounted for	1,398	7,990	2,492	11,880
Cases in process	231	614	62	907
Investigation completed	1,167	7,376	2,430	10,973
Result to date:				
Closed, no change [2]	617	682	2,127	3,426
Closed, survey [3]	513	6,657	271	7,441
Total closed	1,130	7,339	2,398	10,867
Changes made or proposed	37	37	32	106
Total	1,167	7,376	2,430	10,973

Letters mailed out	12,636
Cases transferred	400
Cases retained	12,236
No reply	356
Cases to be investigated	11,880
Cases in process	907
Cases processed	10,973
Closed, no change	10,867
Changed cases	106

[1] Claim of nonresidence, (b) income less than exemption, verified from reliable source, [illegible] verification as to nonresident status or, if resident, examination of returns.
[2] Based upon examination of resident returns or, if no return, account too small to warrant further investigation.

I have a statement from Mr. Thomas Jefferson

(The statement referred to is as follows:)

COMMERCE AND INDUSTRY
ASSOCIATION OF NEW YORK, INC.,
New York 7, N. Y., April 10, 1948.

Hon. SCOTT LUCAS,
Committee on Foreign Relations,
United States Senate, Washington, D. C.

DEAR SENATOR LUCAS: This will acknowledge the kind invitation of April 12 from Mr. Emmett O'Grady, assistant clerk of the Committee on Foreign Relations, to appear before the hearing to be held by your subcommittee on the Income Tax Convention with Great Britain, on Wednesday, April 17.

Since we will be unable to have a representative appear to present our statement in favor of the adoption of this convention I will appreciate your incorporating in the official record the enclosed statement of this association with regard to the tax convention.

Sincerely yours,

THOMAS JEFFERSON MILEY, *Secretary.*

STATEMENT OF COMMERCE AND INDUSTRY ASSOCIATION OF NEW YORK, INC., FAVORING ADOPTION OF THE CONVENTION BETWEEN THE UNITED STATES AND GREAT BRITAIN WITH RESPECT TO TAXES ON INCOMES AND ESTATES

RECOMMENDATION

The provisions of the pending convention between the United States and the United Kingdom of Great Britain and Northern Ireland conform substantially to the conventions which have been adopted in the past. The Commerce and Industry Association of New York, Inc., believes that double taxation of incomes and estates of residents and corporations in the United States and the United Kingdom should be halted.

This association urges adoption of the Tax Convention by the United States Senate.

REASONS

Discriminatory taxation of foreign business and investment is a practice that must be avoided or corrected if we are to enjoy free and uninterrupted international economic and financial intercourse.

Business enterprise has always tended to expand beyond national frontiers. Communications are rapid, raw materials are located in distant lands and production depends upon the maintenance of large foreign markets.

It has become vital, therefore, to give particular attention to the taxation problems of these international enterprises. Each country makes its own tax laws, so that difficult and intricate questions arise as to the taxability of businesses operating in more than one country.

Disputes over the operations of foreign enterprises or their taxation frequently constitute a direct cause of international friction. It is highly desirable to lessen the number and diminish the significance of such disputes, not so much because in extreme cases they may lead to unfriendly acts, but because they undermine the basis of cooperative economic relations.

There are obvious hardships to individuals caused by double taxation of their investments, and there are equally obvious cases where foreign enterprises may be used as a means of physical evasion or where they contribute less than they take from a national economy. As in most cases where economic activity crosses national boundaries, national action can never provide an adequate solution for such hardships, evasions, and exploitation. International agreement is called for on just and fair principles to be applied by the governments concerned.

The worst damage done by double taxation lies in the barriers which it presents to a further development of efficient enterprise.

It should be emphasized that without such agreements double taxation is likely to hinder international enterprise and checkmate efforts to promote international economic cooperation. The unfettered exercise of unlimited national sovereignty is as dangerous in the field of taxation as elsewhere.

Only by mutual agreement on the application of principles that are fair to all parties concerned, business and government, debtors and creditors, can it be hoped to establish mutually advantageous international economic cooperation.

Senator CHURCH. There must be a mistake that you got involved with the rest of this panel.

Mr. BERGER. As you can see, article 17 is a long ways from——

TREASURY RESPONSE TO MR. BERGER SUGGESTED

Senator CHURCH. You raise a question. It may be this kind of treatment is susceptible to constitutional protection. I think that we probably should hear from Treasury in view of your argument on the reasons for this particular treatment for actors and musicians and athletes. I will ask for some rebuttal testimony so that the committee can take your argument into account.

We have one panel left. I would hope that we continue to follow the rule with the understanding that your written testimony will be included in the record in full.

Our first panelist is William D. McKee on behalf of the Committee on Foreign Banks in support of the United States-United Kingdom Income Tax Treaty, San Francisco.

STATEMENT OF WILLIAM D. MC KEE, ON BEHALF OF THE COMMITTEE OF FOREIGN BANKS IN SUPPORT OF THE UNITED STATES-UNITED KINGDOM TAX TREATY

Mr. MCKEE. My name is William McKee, and I am an attorney from San Francisco. I am accompanied by Mr. Robin Campbell, president of the Hongkong Bank, of California.

I am here today representing a group of 14 foreign banks doing business in California. The parent companies of these banks are located in Mexico, Canada, Japan, France, West Germany, and Hong Kong. Several of them are government owned or act as central banks for their governments. These banks are not directly covered by the treaty, but they believe that if article 9(4) is adopted similar protection will ultimately be extended to them. Also, many of these banks have been assessed on the basis of the worldwide formula. They are aware of the discrimination which results from the method, and they believe that they should bring this experience to your attention.

INCOME APPORTIONMENT FORMULA FOR STATE TAX PURPOSES

The problem of apportionment of income for State tax purposes has a long history and we do not quarrel with its use to apportion interstate income. However, in extending the formula worldwide the California Franchise Tax Board has been carried away by a desire for more revenue, and by a perception of a theoretical validity for the formula which is at best dubious. In fact, the formula has been accepted as it operates in the United States only on pragmatic grounds. When it is applied to foreign based multicorporate groups, the resulting distortions expose the weaknesses of the formula, clear double taxation of foreign source income results, and impossible administrative problems are presented. Most importantly when applied to foreign based businesses the formula does not receive that consensus of support and perception of fairness which is essential for any tax system to work in an international context.

In the case of international banking the formula as applied worldwide has the clear effect of taxing in California income earned abroad.

It is general knowledge that the two biggest banks in the United States derive a disproportionately large amount of their income from activities abroad. So, too, foreign banks do much better abroad than here. The most important reason for this is that that interest rate spreads are higher abroad than here. As some indication of this, as of June 25, 1977, the prime rate in the United States was 6.75 percent, but in Canada it was 8.25 percent, in the United Kingdom it was 9.50 percent, and in France, Mexico, the Philippines and Italy, just to take some examples, the prime rates ranged from 11 percent and 20 percent.

The allocation factors also work to tax foreign source income. Substantially higher wage rates prevail in the United States than abroad. Also many foreign banking concerns do a wholesale rather than a retail banking business here. They make relatively large loans to large businesses on a very small spread. As a result, foreign owned banks have relatively large payroll, property and sales factors in the United States as compared with the income they generate. The formula thus works not only on an income base which includes high worldwide profits having no connection with California, but the factors are also disproportionately weighted in favor of California.

EXAMPLE OF HONG KONG BANK OF CALIFORNIA

The Hong Kong Bank of California presents an example of what happens in practice. It is a relatively small banking subsidiary of Hong Kong and Shanghai Banking Corp., whose headquarters are in Hong Kong. It has nine branches in California and about 225 employees, only one of which is from the foreign staff of the parent company. More than 98 percent of its depositors and borrowers are California residents. It does very little business with its parent company. Yet under the tests traditionally applied it may be doing a unitary business with its parent.

The parent company has offices directly or through subsidiaries in approximately 40 countries of the world. The accounting practices of its subsidiaries vary from country to country in accordance with accounting procedures in effect in each jurisdiction.

The Hong Kong Bank of California has become thoroughly familiar with the impossible administrative problems of complying with California's combined report system. These problems are detailed on pages 12 through 17 of the materials which we have delivered to your committee for inclusion in the transcript. The problems are such that for the most part they have simply been ignored, and as a result the assessments which have been made constitute only a very rough approximation of the liability under the method.

You should appreciate that these administrative problems are now being experienced only with the State of California. However, at its meeting held in May the Multistate Tax Commission unanimously adopted a resolution that all States should go unitary worldwide. There are some 25 members of the Multistate Tax Commission. The Commission has done nothing to provide for uniformity in the allo-

cation factors for banks, or in the tax base of each of the States, or in the determination of what is a unitary business. In other words, each State is free to enact and interpret its own law in its own way and in fact does so. The administrative burden is impossible to begin with. It becomes absurd when multiplied by 25 or by 50.

Let me tell you now what results have been experienced in applying the formula to the Hong Kong Bank on a worldwide basis.

First, because the California bank has only about 4 percent of the property, wages and interest income of the worldwide operations of the parent, the local bank's profitability is irrelevant in determining how much of the worldwide income is allocated to California. The bank is required to pay essentially the same amount of California tax whether it has a profit of $1 million in California or a loss of the same amount.

On page 10 of the materials which we have submitted is a schedule that shows all of the nonforeign owned State banks in the same asset category as the Hong Kong Bank of California and it shows their income in relation to their assets for 1972. There is a pattern among these banks indicating that on the average State banks earn approximately 1 percent on assets. In fact, Hong Kong Bank of California earned less than 1 percent on assets in 1972 because it had some bad debt losses on loans made to California residents in that year. Its net income before tax in that year was $707,000. As adjusted by the Franchise Tax Board however, the income of the Hong Kong Bank of California was increased almost sevenfold to $4,832,000 and they assessed a California tax of $560,000. The effective rate of California franchise tax on the bank's actual income becomes approximately 79 percent instead of the statutory tax rate of 11.6 percent for that year.

At the present time the Hong Kong Bank of California has outstanding against it proposed assessments of franchise tax for open years exceeding $4 million. Eighty-seven percent of this tax is the result of the application of the worldwide unitary formula. This amount exceeds the total income of the bank for the 21 years it has been in existence. Unless a prompt solution to its California tax problem is forthcoming it has announced that it will leave California. When California claims it will lose $15 to $20 million if article 9(4) is adopted, it includes these dollars from the Hong Kong Bank of California.

Mr. Chairman, I submit that this is not paranoia on the part of foreign companies and it is not minutia. This is gross interference with the foreign commerce by the United States. This cries out for Federal remedy. This example also shows that formula apportionment is not just a substitute for reconstructing intercompany transactions on an arms-length basis. The formula applies even though there are no intercompany transactions. The States want to apply the formula worldwide to foreign based companies because they get a lot more tax money that way. And they get it from the owners of companies who have no representatives in the Congress or in the State legislature. The formula has a built in bias in favor of the United States because of our high costs of operation. If the U.S. Government went to formula apportionment instead of arms length accounting it would substantially eliminate foreign investment in the United States.

ARTICLE 9(4) AS NATURAL RESPONSE TO NEW DEVELOPMENT

Income tax treaties have the fundamental purpose of avoiding double taxation. The Hong Kong Bank example represents a clear showing that the unitary formula as applied on a worldwide basis necessarily results in the taxation of foreign source income. Since that foreign source income is also subject to taxation in the jurisdictions in which it is actually earned, double taxation results. Article 9(4) prevents that double taxation in the limited area to which it applies. It is true that the treaty extends its protection against double taxation to taxes imposed by the States. But the reason this protection against State taxation has not previously been dealt with in these specific terms is that it has not been necessary. It is only in the last 4 years that any State has conducted a serious campaign to tax foreign based companies. Article 9(4) is thus merely a natural response to a new development in the field of double taxation.

If treaties are appropriate vehicles to prevent double taxation by the Federal Government, why are they not appropriate vehicles to prevent double taxation by the States? If treaties cannot be used to control interference with foreign commerce by local governments, what recourse would American companies have if the city of London or the State of Sinaloa in Mexico imposed a tax on the worldwide profits of American companies doing business there?

So I say that treaties are the appropriate vehicle to provide protection for foreign businesses which are being abused by our States. Those foreign businesses complain to their governments who take up the questions through the diplomatic channels where they are resolved. That is the method that our Constitution provides—through negotiation and treaty.

Moreover, on the basis of the testimony which you heard yesterday and today, article 9(4) is really nothing new at all. At the present time the tax treaties which are in force with the United Kingdom, France, Japan and 10 other countries contain provisions which prevent not only the Federal Government but also the individual States from discriminating against foreign-owned businesses operating within their borders. So do the treaties with Korea, and the Philippines, which are also now being considered by your committee. These provisions not only prevent the States from imposing higher taxes on such foreign-owned businesses but also prevent them from imposing any more burdensome requirements connected with taxation than are imposed on U.S.-owned businesses. In general foreign operations are more profitable in relation to the allocation factors than are U.S. operations. That is why the States want to tax foreign operations under the formula. It is also demonstrative that it is more burdensome for foreign-based corporations keeping their accounts on foreign based concepts to comply with combined report procedures. It follows that present treaties already prohibit, in more general terms than article 9(4), the States from using the allocation formula of a worldwide basis in many instances. Article 9(4) is then only a clarification or at most an extension of language which has appeared in income tax treaties for more than 40 years. And, as previously pointed out by Mr. Nolan, the 1959 French Commercial Treaty has language which is almost as direct as is article 9(4).

Thank you for this opportunity to appear before you, Mr. Chairman.

Senator CHURCH. Thank you very much.

[The additional material referred to is in the committee files.]

STATEMENT OF BRUCE K. DENEBEIM, SENIOR VICE PRESIDENT, THE CHARTERED BANK OF LONDON, SAN FRANCISCO, CALIF.

Mr. DENEBEIM. Mr. Chairman and members of the committee. For the record, my name is Bruce K. Denebeim and I am senior executive vice president of The Chartered Bank of London and an attorney-at-law. I have registered under the Foreign Agents Registration Act of 1938.

The Chartered Bank of London is a California corporation organized in that State in 1964 and is a wholly-owned subsidiary of the Standard Chartered Bank Limited, headquartered in London. The parent bank is a truly multinational corporation in that it has over 1,600 offices located in over 60 countries throughout the world.

The California operation is a separate State banking corporation in that we ourselves have 16 branches with assets in excess of $300 million, and we employ in excess of 650 people, of whom only two have direct employment ties to our parent and only one is in an executive position.

My purpose in appearing here today is to encourage this committee and through it the U.S. Senate to ratify and confirm the United States/United Kingdom Income Tax Treaty as it is written, with particular reference to article 9(4) dealing with the unitary tax theory. It is my purpose in addressing you at this moment to relate to you in some detail the effect the unitary tax theory would have upon our institution.

Please understand that as of this moment the Franchise Tax Board has not yet established that our bank is subject to the unitary tax theory. That very matter is pending the completion of an investigation of our practices and procedures by the Franchise Tax Board since 1972.

UNITARY TAX METHOD'S EFFECT ON CHARTERED BANK OF LONDON

When our California bank was founded by its parent in 1964, it brought to California by way of capital and surplus $2,500,000. For the next 10 years, the parent invested in that California operation in excess of $20 million by way of capital, surplus and other financial support.

Like most other newly founded organizations, in the early years our tax payments to the State of California were not significant. I can tell you in fact that for the first 7 years our franchise taxes barely exceeded $11,000.

After our initial founding problems were overcome, our tax returns have shown payments to the State of California on a simple corporate theory in excess of $765,000.

In 1974, in order to accomplish an acquisition, the parent invested an additional $16 million. In 1976, the parent further increased

the capital structure of our bank by $10 million representing a total investment in California to date of $46 million.

Early in 1977 the parent, in its decision to acquire another California banking institution, publicly announced its willingness to invest additional sums in excess of $180 million.

During this period of time the parent was ready to and did commit to furnish further and additional capitalization as may be required by the banking authorities to maintain our capital structure in line with the deposit position.

What we are talking about now is the balance-of-payments and willingness to invest additional money in California without the imposition of unitary tax theory.

Basically the unitary tax theory would disregard our California operation for State income tax purposes and would result in the imposition of a tax based upon the profits or business activities of our parent on a worldwide basis.

The unitary tax theory uses a very complicated formula in order to determine whether or not it is applicable with a particular California operation.

If the first threshold is crossed and a determination is made that an organization is subject to this theory, an even more complicated accounting problem is generated for a multinational corporation—complicated because a United Kingdom headquartered company has very strong feelings in obeying the law wherever sited, which includes accounting procedures and tax laws.

For purposes of determining the correct unitary tax, those accounting procedures, tax laws, in addition to salary computations and determination of assets, must be readjusted to conform to California regulations so that what appears to be a simple formula can be followed.

When you translate these accounting and tax problems to a multinational corporation such as ours, where we must conform to 60 different countries, you can appreciate the burden of the unitary tax theory.

The ingrained British philosophy of fairness is deeply touched by the application of the unitary tax theory to profits on a worldwide basis when those profits were not generated from or as a result of the California operation in any degree.

This bank and its parent understand liability for taxes to the State of California based upon a profit picture generated in California, but we do object to paying taxes on profits which have no relation to California, and this is the unitary tax theory.

UNITARY TAX THEORY'S EFFECT REGARDING MULTI-NATIONAL CORPORATIONS

Let us examine for a moment the effect of the unitary tax theory with reference to multinational corporations who would be interested in doing business in California.

Based upon our personal knowledge as bankers, we can advise you that at least four other multinational corporations have examined the economic scene in California and are currently reluctant to establish offices and businesses in California.

One important factor of their decision making was based upon the potential liability of unitary tax and knowing full well that the initial years of their operations in California, as ours were, may not be profitable, yet their tax liability in California would be substantial based upon their worldwide operations, again, without relation to their business operations in California.

The effect of the unitary tax theory, is that it is not a development assistance, but rather the unitary tax theory becomes a development penalty. I think in effect you are looking at a substantial part of our balance of payments program which is inhibited by States in the application of the unitary tax theory.

UNFAIRNESS OF UNITARY TAX THEORY

In order to demonstrate further the unfairness of the unitary tax theory, I can tell you that it is entirely possible in our own case that the application of this theory might even result in less taxes paid to the State of California, if our particular operation were profitable, as it has been, and if our parent's operation worldwide became unprofitable, which it is not.

In applying the theory on an absolute consistent basis, I would visualize in such a case the payment of less franchise taxes.

UNEXERCISED RIGHTS OF FRANCHISE TAX BOARD

Our local Franchise Tax Board has the power and authority under our Revenue and Taxation Code, section 24725, to adjust the income, expenses, profit, or loss of our bank in the event we have not dealt on an arm's length basis with our parent or affiliates.

In the event we filed a consolidated tax return, our Franchise Tax Board has the authority under sections 25102 and 25103 to make the same adjustments on such a tax return. There can be no argument with valuing our stock in trade, which is money, or our business operations.

The exchange of money, the charging of interest, or generally running a bank is neither secretive nor beyond reasonable pricing criteria. We believe that any qualified revenue agent of our Franchise Tax Board could make these adjustments and require an amended tax return without building a superficial bureaucracy or increasing cost of operating the Franchise Tax Board.

This is the same power and authority the Internal Revenue Service has under its section 482.

What the Franchise Tax Board is telling us is that they are either unwilling or incapable of exercising their rights and power as the taxing authority with reference to a California corporation if it happens to be part of a multinational group.

My experience as an attorney is that the Franchise Tax Board is very capable of reviewing and adjusting improper tax returns or recordkeeping by a taxpayer.

We must, therefore, conclude that the position of the Franchise Tax Board in applying this unitary theory with reference to multinational corporations appears to represent an indifferent and unfair system and obviously more complicated and costly to administer.

Witness, if you will, the fact that the Franchise Tax Board has investigated our bank since 1972 without yet determining that it is even subject to the unitary tax theory.

Were we audited, based upon our tax return, I can assure you the revenue agent would have long ago concluded his investigation and adjustments accepted.

The steps of determining whether or not the tax theory would apply and procedures a multinational corporation must go through to establish the basis of the formula would remind you of a novel written 200 years ago by Jonathan Swift wherein you will recall in Gulliver's Travels the various exercises which the King's subjects were required to undergo in order to establish their fitness to serve their king and country.

CONSIDERATIONS CONCERNING TAX TREATY WITH ARTICLE 9(4)

In deciding whether or not the U.S. Senate should advise and consent to a tax treaty with article 9(4), one must consider whether or not foreign investments in the United States should be encouraged or discouraged and whether or not American investments in foreign countries should receive reciprocal tax treatment.

The Tax Treaty does not tell California or any State how much they can or cannot tax, or what they can or cannot levy a tax upon, but only that they cannot by overreaching in their method of taxation, impair this country's ability to attract investment and employment. It has been stated by our Supreme Court that the power to tax is the power to destroy. I have tried to make clear in my presentation the investment our parent has made without the unitary tax theory and the reluctance of other United Kingdom based companies to invest in California, which may be subject to that theory.

If the right of a State to levy taxes on business conducted outside of this country is sacrosanct, then of course foreign investment and international trade may very well suffer. And this appears to me to be a matter of foreign relations, which the Constitution of this country has given to the U.S. Senate based upon this committee's recommendations.

We firmly believe that no multinational institution should be subjected to the unitary tax theory and we more firmly believe that the proposed United States-United Kingdom Income Tax Treaty intends to eliminate double and unfair taxation by reason of article 9(4).

Without this treaty as it is currently written, an unfair taxing system which inhibits international trade and investment would continue and we believe this is wrong for an important part of an economically strong State.

Thank you very much for allowing me to make this presentation.

Thank you, Mr. Chairman.

[Mr. Denebeim's prepared statement follows:]

PREPARED STATEMENT OF BRUCE K. DENEBEIM

Mr. Chairman and Members of the Committee. I am Bruce K. Denebeim, a third generation American citizen. I am the Senior Executive Vice President of The Chartered Bank of London, an Attorney at Law, and I have registered as a representative of a foreign organization pursuant to Section 2 of the Foreign Agents Registration Act of 1938, as Amended.

The Chartered Bank of London is a California corporation organized in that State in 1964, insured by the Federal Deposit Insurance Corporation, and is a wholly-owned subsidiary of the Standard Chartered Bank Limited which is headquartered in London. Although the parent bank is a truly multi-national corporation, has over 1,600 offices, located in over 60 countries throughout the world, the California corporation is a separate State banking corporation with its own Board of Directors, executives, and 16 branches with assets in excess of $300 million. Perhaps more important to this Committee is the fact that we employ in the State of California in excess of 650 people, of whom only two have any direct employment ties to our parent and only one of which is in a senior management position.

My purpose in appearing here today is to encourage this Committee and through it the United States Senate to ratify and confirm the United States/United Kingdom Income Tax Treaty as it is written with particular reference to Article 9(4), dealing specifically with the so-called unitary tax theory. As previously stated to this Committee, the unitary tax theory, as currently practiced in California, has an adverse effect upon our banking institution as well as other business enterprises attempting to conduct business and provide employment in California. I shall relate to you some of the details concerning this problem as they specifically refer to us and other banking institutions. I should like to leave to others who are better qualified and more experienced to advise you in general as to the effects of the unitary tax theory on other types of organizations and the general economic and tax consequence.

As a California bank we are regularly examined or audited by the Federal Deposit Insurance Corporation, State Superintendent of Banks, Haskins and Sells, who are our independent auditors, as well as our own internal auditors. Each examination takes about 30 days to complete and employs over 15 examiners to conduct the examination. We usually average at least one examination by each group every year. Each examining group is charged with the responsibility of examining our books, records, hundreds of thousands of transactions, compliance with literally thousands of laws and regulations as well as to insure that the bank maintains good accounting practices. Since the Federal Deposit Insurance Corporation and State Superintendent of Banks are charged with the responsibility of protecting our depositors, they are especially attuned to any practice that might divert profits belonging to the California subsidiary in favor of any foreign interest.

Because we are California bankers, we try to run our banks as independently and successfully as possible, but under the unitary tax theory we do not know where we stand. In addition to our regular examinations we have been under continuous audit on this point from 1967 through 1973. The Franchise Tax Board has changed auditors over 4 times and each time we have had to start from the beginning with each new auditor. The current auditor has promised that he will tend to this matter until it is completed. He has investigated this problem for over 2 years and recently was transferred to the San Jose office. He still is diligently working on the problem.

Our basic problem with the unitary tax theory is that it eliminates the distinction between our California operation and the totally unrelated operations of the parent Group in some 60 overseas countries for State income tax purposes and imposes a tax based upon the profits or business activities of our parent on a worldwise basis, which is delineated in many currencies and various local rules. The unitary tax theory, whose formula may appear simple in operation, nevertheless disregards our actual California operation, be it profitable or at a loss, and dictates a tax liability as to the profit position of the parent bank, wherever situated and wherever earned. In order to appreciate the unfairness of this theory in establishing tax liability, it would be helpful to know that when our California bank was founded by its parent in 1964, it brought to California by way of capital and surplus $2,500,000. For the next five years the parent invested in California considerable additional capital indicating strong financial support. Like any other newly established organization in its early years, its losses in California were significant. Operating and loan losses occurred in transactions with California enterprises and not in inter-company dealings with overseas subsidiaries or customers. As a result of these losses no Franchise taxes were paid. If our bank had not been a subsidiary of a foreign bank, that would have ended the matter. A simple audit to verify the nature and character of the losses would have been made and the returns would have been accepted as filed; however, this is not so. The Fran-

chise Tax Board's position seems to be that even though you lost money on your California operation, totally within California, you made money somewhere else and with an arbitrary formula you pay whether you win or lose.

California is the largest State in the Union and a tremendous amount of business is transacted throughout the State. Since 1964 our parent has invested over $46 million in California and, fortunately, through its early lessons in lending in California, has been operating profitably. Since 1974 we have paid over $765,000 in California Franchise Taxes computed on the same basis as any other California Bank.

I think you should appreciate the difficulties in detail which are encountered by a California corporation undergoing this investigation by our local taxing authorities. In addition to the tax agent spending a great deal of time going through our corporate records, correspondence, asking questions of staff members as to policies and procedures, reiterating corporate structure and questioning our Board of Directors and executives in some detail over a considerable period of time, we recently received a request for additional details and I will leave to this Committee the decision as to whether or not these details appear esoteric in practice as well as in theory. Please bear in mind that simple cooperation with the State Banking Department Examiners or Federal Deposit Insurance Corporation Examiners would have solved these questions for the present auditor without further interference with the daily conduct of our business.

Question number 2 of a June 27th letter from the Franchise Tax Board refers to customers common to both our parent and the subsidiary and inquiries whether the parent maintains a total loan commitment limit that would include the subsidiary and, if so, would the parent limit the amount of a loan that the subsidiary could make based upon a worldwide loan limit. Further, a list of 23 selected loans, which had been approved by our California Board of Directors was provided asking if we would advise the Franchise Tax Board if there existed a connection between the California bank and its parent with reference to making the loans, i.e. business referred to The Chartered Bank of London by its parent, common customer of The Chartered Bank of London and its parent and then, of course, an all-inclusive question of what criteria is used to classify a loan as "international." Please understand that responding to these questions by executives is one thing, but finding loan files dating from 1972 and earlier to be analysed by the staff, many of whom no longer are employed, is, of course, quite a different matter and of some burden to any organization desiring to increase, grow and retain profits in order that it can pay taxes.

I must tell you that a major consideration by our parent in increasing its position in California and investing substantial dollars in our operation has heretofore been made without consideration or fear of the imposition of the unitary tax theory. Let me tell you exactly how much additional capital the parent has brought to California. Up to 1974, the parent had invested close to $20 million. In 1974, in order to accomplish an acquisition, the parent invested an additional $16 million. In 1976 the parent further increased the capital structure of our bank by $10 million representing a total investment in California to date of $46 million.

Early in 1977 the parent stood ready to invest additional sums of some $180 million. Such sums could have provided over 3,000 jobs for Californians. I can tell you that all during this period of time the parent was and did commit to furnish further and additional capitalization as may be required by the banking authorities to maintain our capital structure in line with good practice in the industry. An increased capital is important to support increased growth in the banking business which in turn supports the public convenience and necessity in California. These decisions, Gentlemen, were based simply upon the willingness of the California organization to pay its tax liability to the State of California without fear of subjecting the worldwide profit structure of the parent to a tax liability in California, which has no relationship to its California operation.

The ingrain British philosophy of fairness is deepely touched by the application of the unitary tax theory to profits on a worldwide basis when those profits were not generated as a result of the California operation in any degree. This bank and its parent will represent to this Committee that it is perfectly willing to pay taxes to the State of California based upon a profit picture gen-

erated in California, but it does object to paying taxes on profits which have no relation to California, and are assessed by an arbitrary theory unrelated to banking in general and not employed anywhere else.

What does the unitary tax theory accomplish for the taxing authorities? As we see it, the application of the unitary tax theory permits the taxing authorities to disregard the legitimate operations of a taxpayer in California when it suits California's convenience. The Franchise Tax Board does not have to concern itself with the rights and wrongs of the taxpayer in its bookkeeping or the operations of its business. The Franchise Tax Board does not have to investigate or examine records with reference to the application of income and expenses or profits. It may ignore legions of duly appointed examiners and auditors who are especially trained to examine banks and by the adaptation of such a theory, the work and the functions of the Franchise Tax Board are minimized, its responsibility shifted to an arbitrary formula and taxes to which it is not entitled are collected. If the Franchise Tax Board was unable to investigate, audit, or perform similar taxing functions with its taxpayers and see to the proper allocation of income, expenses and profit, then, Members of the Committee, I must agree a unitary tax theory does become a simple and expedient method of establishing tax liability on someone.

What authority does the Franchise Tax Board have to audit and adjust a taxpayer's records with reference to its financial procedures? The United States Internal Revenue Service is benefitted by Section 482 of the Internal Revenue Code wherein improper allocations of profit or loss can be adjusted to reflect fairly the tax liability of the taxpayer whether within or outside the United States. The Internal Revenue Service has no difficulty in applying Section 482 when and if a taxpayer has violated the spirit or letter of the Internal Revenue Code. The Franchise Tax Board has the same power and authority under the California Revenue and Taxation Code, Section 24725, to make the same adjustments in case of improper allocation, especially with the aid of trained bank examiners. In addition, the Franchise Tax Board can seek the benefits of Section 25102 and 25103 of the same Revenue and Taxation Code to satisfy itself in the case of a consolidated return that a proper income tax has been reflected by a taxpayer. What the Franchise Tax Board is proclaiming in the application of the unitary tax theory is either that they are incapable or unwilling to exercise their rights and power as a taxing authority or they want to collect taxes they simply are not entitled to as a result of California operations. Based on my personal experience as a taxpayer in California for the past 22 years I do not agree. On the contrary, my experience as an attorney with special interest in taxation is that the Franchise Tax Board is very capable of reviewing and adjustng improper tax returns or record keeping by a taxpayer, especially as it pertains to the banking industry. We must, therefore, conclude that the position of the Franchise Tax Board with reference to the unitary tax theory appears to be an indifferent and unfair system.

Let us examine for a moment the effect of the unitary tax theory with reference to multi-national corporations who would be interested in doing business in California. Based upon our personal knowledge as Bankers we can advise your that four other multi-national corporations have examined the economic scene in California and currently are reluctant to establish manufacturing businesses in Californi. One important factor of their decision was based upon the potential liability of unitary tax and knowing full well that the initial years of their operations in California, as ours were, would not be profitable, yet their tax liability in California would be substantial anyway based upon their worldwide operations, again, without relation to their business operations in California. The effect of the unitary tax theory, Members of the Committee, is that it does not aid or assist development but I can tell you the unitary tax theory becomes a development penalty. I think in effect you are looking at a substantial part of our balance of payments program which can be inhibited by States if they also choose to apply the unitary tax theory and also severely affects the unemployment situation. Our bank has demonstrated its interest in investing in California in the absence of a finding that we are subject to the unitary tax theory. Our parent contributed in excess of $46 million to the California economy, however, the other companies with which we are specifically familiar who have considered investments represent a reluctance to invest in California in fear of unfair taxation.

Let us examine for a moment the findings the taxing authorities must establish in order to apply the unitary tax theory, and I think you will agree that going through the steps of determining whether or not the theory would apply to a particular taxpayer would remind you of a novel written 200 years ago by Jonathan Swift wherein you recall in Gulliver's Travels the various exercises which the King's subjects were required to undergo in order to establish their fitness to serve their king and country. The Franchise Tax Board must determine that our Bank is not independent in management or operation. Officers of the Franchise Tax Board have openly stated they cannot imagine any such situation where there is no such control. Therefore, whether our books and records are accurate would be deemed immaterial and our bank is strictly controlled and regulated by our parent in London. As such our books and records do not particularly reflect our profit and loss, therefore, the theory would apply. It is this determination, Members of the Committee, which has not yet been finally determined after 6 years of investigation.

Our Board of Directors consists primarily of California residents who have been successful in business or professional careers outside of banking and who exercise strong determination of independent thinking and corporate responsibility. The management of our bank, in day-to-day normal banking functions, rests strictly with California residents. Almost all of our business is conducted in California with California enterprises. I doubt that I or my colleagues would retain our positions long with The Chartered Bank of London if we did not indeed exercise independent judgment and management functions. To say that we are wholly independent of our parent would be a misnomer. Because of our parent's large investment in California we strongly believe that the parent should have some right to suggest overall corporate policy, but leave the day-to-day management to local talent skilled in corporate policy and the California scene.

Because of the shift in population in the United States, which we all have witnessed since 1946, California has enjoyed a tremendous influx of people, both from within this country and from without. I believe the migration to California represents the largest migration known to man. What this means in the financial field is that California traditionally has been short in capital for financing its economic growth. As a result, any encouragement in a free market for capital funds has been found to be beneficial by infusion of capital and should be encouraged and not discouraged or inhibited on a State or local basis when so much is at stake for the citizens of California and other States where such a thrust for tax revenue would sharply limit sound economic growth.

The responsibility of management of our Bank to our parent is no different than the degree of responsibility a normal corporation would hold to its shareholders. Please understand, Members of The Committee, that our parent is a publicly held institution with its stock traded and quoted on the London Stock Exchange, and managed by a Board of Directors who are elected in normal corporate procedures by its shareholders on an annual basis.

We firmly believe that no institution should be subjected to the unitary tax theory and we more firmly believe that the proposed United States/United Kingdom Income Tax Treaty intends to eliminate double and unfair taxation with reference to Article 9(4). Without this Treaty as it is currently written, an unfair taxing system which inhibits international trade and investment would continue.

I would point out to the Committee that according to the United States Bureau of Economics' analysis of foreign business investments as of October 1976, the United States had already invested in excess of $13 billion in the United Kingdom, and companies in the United Kingdom had only invested over $6:5 billion in the United States. I think, Senators, when you look at the total figures you will appreciate the need of the United States/United Kingdom Income Tax Treaty.

I am sure this Committee is aware of the exhaustive study made by a former Superintendent of Banks in California concerning the charter of foreign banks in California, which resulted in complete agreement that foreign banks in California not only benefitted the State but also its residents

Thank you very much for allowing me to make this presentation to you.

Senator CHURCH. Thank you very much for your testimony.

UNITARY TAXATION ELSEWHERE THAN IN UNITED STATES

Do either of you gentlemen know any other country that applies the unitary tax?

Mr. McKee. No, sir, I understand the EEC considered it and rejected it.

Senator Church. I would like to ask the Treasury Department to submit in writing to the committee any information that the Department may have relating to unitary taxation elsewhere than in the United States and what steps we are taking to deal with that question if in fact it does exist.

REASON FOR SINGLING OUT ACTORS, MUSICIANS, AND ATHLETES

I would also like to ask the Department, in view of Mr. Berger's testimony, for a written statement explaining why actors and athletes and musicians have been singled out for special tax treatment in the treaties that is less favorable than which is extended to all other citizens with respect to income earned.

Senator Javits has asked for you to comment on the testimony from the State of California which is adverse to the treaty.

For this purpose and for the purpose of letting any other interested witnesses supplement their remarks or supply additional information, the record will remain open for two weeks.

[The information referred to follows:]

MEMORANDUM ON ISSUES RAISED IN TESTIMONY BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS IN CONNECTION WITH THE PROPOSED INCOME TAX TREATY WITH THE UNITED KINGDOM

[Supplied by Treasury Department]

This memorandum responds to the Committee's request for supplemental Treasury submissions in respect of three matters concerning the proposal United Kingdom tax treaty:

1. A response to issues raised by the testimony of Kenneth Cory, Chairman of the California Franchise Tax Board, regarding application of the treaty to California's use of the unitary tax system;

2. A response to testimony by Paul Berger, on behalf of the Screen Actors Guild, objecting to the treaty provision in respect of entertainers; and

3. Estimates of the tax revenue impact of

(a) The refund of British advance corporation tax, and

(b) The treaty provision permitting petroleum revenue tax to be credited against United States tax.

Apart from this memorandum, the Treasury has responded to the two other requests made at the July 19–20 hearings:

First, we have requested the President to give us a letter stating that the lack of agreement on an airline provision in the Philippines treaty will not be treated as a precedent in future treaty negotiations;

Second, a representative of the Treasury has spoken by telephone with the Tax Administrator for the State of Rhode Island and confirmed, both orally and by letter, that Article 7 of the proposed treaty with the United Kingdom will no affect he taxing power of Rhode Island or of any other state.

PART I.—RESPONSE TO TESTIMONY OF KENNETH CORY

The Treasury Department is pleased to have the opportunity to respond to Mr. Cory's oral and written testimony.

Item 1

Mr. Cory states that this treaty is a fundamental attack on California's historic unitary tax system. In fact, it applies only to a small part of the unitary system, the portion dealing only with foreign-owned operations, a portion adopted by an administrative practice instituted by California within the last five years.

Item 2

Mr. Cory's estimate of the revenue loss to the State of California is much overstated. His oral testimony states[1] that the $125 million annual revenue loss to California was from the treaty "as originally presented." This, of course, is not the same provision.[2] The Chief Counsel of the California Franchise Tax Board has publicly estimated the revenue cost to be less than one-sixth of Mr. Cory's estimate.[3] Thus, the revenue loss is less *than one-fifth of one percent of California's 1976 tax revenues.*

Item 3

Mr. Cory complains that California was not consulted. However, when his objection was made known, it was taken into account. Mr. Cory's testimony states that "[a]fter the Treasury Department was contacted by California, the treaty was revised. . . ."[4]

Item 4

Mr. Cory states that the treaty is an "end run" by American "special interests"[5] around the domestic legislative process. In fact, the provisions was requested by the British. It does not benefit United States-controlled companies.

A further explanation of the facts behind Items 1 through 4 follows:

Item 1—What the Treaty Does.

To explain what Articles 9(4) of the proposed treaty—to which Mr. Cory objects—accomplishes, it is necessary to discuss how the unitary tax system has expanded. States may tax income which is apportioned to the state. When a corporation does business both within and without a state, a state will generally apportion the company's income in accordance with a three-factor formula—the proportion of the company's sales, property, and payroll within the state. Thus, if one-third of the company's total payroll, sales and property is in the state, one-third of its total income is apportioned to the state.

Step 1 in state taxation is therefore to apply the three-factor formula to the income of corporations doing business in the state.

Step 2 applies the three-factor formula not only to corporations doing business in the state, but also to commonly-owned companies having dealing with such corporations. This is what New York does.[6] It is a much more limited form of unitary system than California's, although Mr. Cory equate the two.[7]

Step 3 applies the formula to commonly-owned domestic corporations, regardless of whether they have dealings with each other. California has done this for a long time.

Step 4 applies the formula to all United States-owned corporations—both domestic and foreign. California did not do this until the late 1960s.[8]

Step 5 applies the formula to foreign-owned foreign corporations which do not do business in California. Step 5 is an administrative practice which California has pursued only within the last five years.[9]

The treaty prevents California only from taking step 5; and it is not clear whether or which other states intend to take Step 5. Information furnished to the Treasury by private parties indicates that Idaho, for example, has not taken Step 5. Thus, what is at stake is not California's historic unitary tax system. It is a recent administrative practice affecting companies which do not, through either business or control, have contact with the United States.

In view of the limited nature of Article 9(4), whether the unitary system or the arm's-length method of taxation is the better one is not a significant issue. In the vast majority of cases, California will be able to use its unitary system; and United States or United States-controlled companies (whether domestic or foreign) will be able to limit application of the unitary system *only* by obtaining

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[1] Transcript, p. 2–52.
[2] See p. 2, State of California Franchise Tax Board Position Paper (Mr. Cory's written statement).
[3] See p. 20, written submission of William D. McKee, and Appendix A of that submission.
[4] Mr. Cory's written statement, p. 2.
[5] Transcript, pps. 2–32, 2–50.
[6] *The Wurlitzer Company* v. *State Tax Commission*, 35 N.Y. 2d 100 (1974).
[7] Mr. Cory's written statement, p. 4.
[8] Wood, International Tax Planning, Canadian Tax Journal, May-June 1977, p. 271 at 273.
[9] Wood, *supra* at 271; Petersen, California Franchise Tax; The Journal of Taxation, March 1976, p. 184.

domestic legislation. Moreover, the basis for Mr. Cory's criticism of the arm's-length system is questionable, since California—unlike New York—applies the unitary system where there are no dealings among the affiliated companies and, therefore, no need to determine an arm's-length price.

Owing, however, to Mr. Cory's attack on the arm's length method,[10] there is attached as Exhibit 1 a memorandum from the Commissioner of Internal Revenue asserting the Internal Revenue Service's ability to achieve satisfactory results with that method. The Treasury does not know of any foreign country which generally uses the unitary method.

Item 2—Estimated $125 Million Yearly Revenue Loss.

As originally signed, the treaty provided that the unitary tax system could not apply to corporations with United Kingdom affiliates. Although the result was not intended, such a provision would have prevented California from applying its system to United States-controlled companies; and California properly objected. The treaty, as conceded by Mr. Cory, was thereafter revised,[11] what is before the Senate applies only to foreign corporations with United Kingdom control.

Unfortunately, the revision in the treaty has not caused Mr. Cory to revise his tax estimates of a $125 million annual revenue loss. At California's 9 percent corporate tax rate, $125 million of lost revenue means $1.3 *billion* less income subject to tax. Since the total United Kingdom direct investment in California is about $1 billion,[12] it is apparent that there will not be $1.3 billion less California income attributable to this treaty. Rather, the $125 million revenue loss estimate reflects two assumptions:

(1) That every treaty country will obtain the same provisions as the United Kingdom;

(2) More important and totally unwarranted, that treaties will prevent California from using Steps 2, 3, and 4. In other words, California will not be able to apply the unitary system with respect to United States-controlled corporations.

With respect to the first assumption, renogotiation of our complete treaty network will not occur for several years; and the Treasury Department will agree to the provision only in the context of a treaty beneficial to the United States. Mr. Cory's assertion that most-favored-nation clauses will engraft Article 9(4) on to other treaties[13] is not correct.

As for the second assumption, nothing in this treaty—or what the Treasury Department might negotiate in the future—will affect Steps 2, 3 or 4.

As stated previously, Counsel for the California Franchise Tax Board has confirmed a public statement that the estimated revenue loss to California if all United States treaties contained Article 9(4) would be about $15-20 million annually. For its 1976–77 fiscal year, California's total tax collections were approximately $10,764,000,000, of which $1,642,000,000 was corporation tax.[14] Thus, the revenue loss for which California would have the Senate jeopardize the tax treaty with the United Kingdom is less than 2 percent of corporation taxes (if all treaties contained Article 9(4) and less than one fifth of one percent of California's 1976 tax revenues.

Item 3—Lack of Consultation with Mr. Cory.

As indicated in Item 2, the treaty was revised after objections by Mr. Cory that its original provisions were too broad.

Item 4—The "End Run."

As previously stated, the British, not the United States, initiated the discussions leading to Article 9(4). Moreover, United States-controlled companies do not benefit from this Article.

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[10] A minor irritant is that the Mr. Keesling quoted at length by Mr. Cory on the unitary tax system and described by Mr. Cory only as a "noted commentator," is in fact a former Counsel to the Franchise Tax Board. Mr. Keesling has been considered to be "father of the combined return concept used by California." See Petersen *Supra*, p. 184.

[11] See text at footnote 2.

[12] The total United Kingdom direct investment in the United States is $7 billion, of which approximately one-seventh has been assumed to be in California.

[13] Mr. Cory's written statement, p. 2.

[14] Preliminary Annual Report for the 1976–1977 Fiscal Year (published by Mr. Cory) at p. 8. The figures do not include taxes assessed at the local level, such as property taxes.

Actually in his testimony Mr. Cory is attacking a treaty provision that no longer exists. As originally signed, the treaty would have restricted California's right to apply the unitary system to companies controlled by United States persons. Owing to objections from California and other states, this is no longer the case. If that were still the case, many of Mr. Cory's claims would be plausible. His revenue estimate might be reasonable, his belief that United States companies were behind the provision would be understandable, and his suggestion that the domestic legislative process would be more appropriate to restrict California's taxation of United States-owned companies would have considerable force.

But it is not the case. Companies incorporated in the United States, companies controlled by United States persons, and companies doing business in California will still be subject to the unitary tax system if this or any other treaty is passed. Mr. Cory still can use Steps 1, 2, 3, and 4. He is plugging a non-existent hole in the dike.

Because Mr. Cory does not make the distinction between Step 5 and the other steps, he does not see that a tax treaty and the Senate Foreign Relations Committee constitute the proper forums in which Article 9(4) should be resolved. Mr. Cory's citation of legislative attempts to restrict the unitary system is totally irrelevant. To begin with, much of the legislation was proposed before California took Step 5. More important, United States citizens have an interest in restricting Steps 2, 3, and 4; they have no interest in restricting Step 5—which applies only to foreign-controlled foreign companies. Accordingly, any domestic legislation affecting United States citizens will be concerned with Steps 2, 3, or 4. By contrast, the sole interest of the United Kingdom concerns Step 5. Its interests are therefore totally different from those of American citizens; and unlike American citizens, the British Government has no representatives either in the Congress or in state legislatures.

California certainly did not consult the United Kingdom before it took Step 5. Nor should it have. The proper channel for the British to discuss application of the unitary system is with the United States Treasury; and their recourse is a tax treaty in which each government asks for specific limits on the other country's taxation.[15] There is no reason why the British need to get involved in domestic legislative questions which do not concern them—Steps 2, 3, and 4—and which raise unrelated issues of concern only to United States citizens.

Conclusion

This is a case of competing interests. On the one hand, what is at stake is the national interest in obtaining non-discriminatory tax treatment for United States individuals and companies that invest overseas. The treaty with the United Kingdom does this, by affording American investors in Britain a tax refund comparable to that obtained by British investors in Britain. The refunds are estimated to be $125 million annually, and approximately $400 million for past years.

The stakes are not confined to Britain alone. Countries like Germany, France and Canada will be watching to see what happens to this treaty. Those countries also give refunds to resident shareholders but not to United States investors.[16]

On the other hand, what is at stake for California is only a recent administrative practice that (after a prolonged period) could at most cost California one-fifth of one percent in tax revenues.

PART II.—RESPONSE TO TESTIMONY BY PAUL BERGER

On behalf of the Screen Actors Giuld, Mr. Berger has objected to Article 17 in the United Kingdom treaty. That Article permits the United Kingdom to tax an entertainer or athlete on amounts earned in the United Kingdom if his gross receipts from Britain exceed $15,000. By contrast an individual other than an entertainer or athlete is not subject to British tax on his earnings unless he is in the United Kingdom for more than 183 days during the year or has a fixed base there.

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[15] The Senate has approved tax conventions which apply identically to national and local income taxes of foreign countries. Article I(1)(b), income tax convention with Norway; Article I(1)(b), income tax convention with Sweden.

[16] France gives refunds to American investors with less than a 10 percent stockholding.

Mr. Berger felt that because high earnings of actors get more publicity than earnings of those in other professions actors were being denied equal treatment; and he raised the possibility that Article 17 could be a constitutional denial of equal protection.

Article 17 is More Favorable Than International Norms

The United States position on treatment of entertainers and athletes is a source of controversy with other countries, but for reasons directly contrary to those advanced by Mr. Berger. Almost alone, the United States insists that there be a dollar threshold below which other countries do not tax U.S. entertainers and athletes . By contrast, other countries insist on taxing visiting entertainers and athletes no matter how little they earn there.[1] Thus, United States entertainers who work in Britain are—if their gross receipts do not exceed $15,000—in a better British tax position than entertainers from other countries who perform there. U.S. entertainers earning over $15,000 are no worse off than entertainers from other countries who perform there and have similar receipts.

Total Tax Burden Should Not Increase

An actor working for a United States company will seldom if ever have to pay more total tax by reason of paying British tax. As indicated in the letter previously sent to Senator Javits, a copy of which is attached as Exhibit 2, entertainers not domiciled in the United Kingdom are generally taxed on only 50 percent of their earnings. The United States will tax 100 percent of their earnings; and, since British tax will be creditable against United States tax, they will have to pay additional tax only to the extent British tax on 50 percent of their United Kingdom earnings exceeds United States tax on 100 percent of those earnings.

Constitutional Question

Finally, we get to the constitutional point raised by Mr. Berger. The Constitution of the United States applies to the federal government and to the states. It does not require Great Britain to give United States citizens equal protection.

If there were such a constitutional restriction, it would mean that the treaty could not provide an exemption for airlines[2] because it did not provide an exemption for actors. The treaty could not provide an exemption for teachers staying in Britain for less than two years[3] because it did not provide an exemption for actors staying in Britain for less than two years. It could not provide an exemption for employees of the United States government[4] because it did not provide an exemption for employees of Twentieth Century Fox.

The Internal Revenue Code itself distinguishes among professions. More favorable estimated tax payment rules are provided for farmers and fishermen.[5] Inventors may qualify for capital gain treatment.[6] Certain allowances of government employees are excluded from income.[7] Although Mr. Berger stated that actors who stay in Britain a short time were not treated as well as producers, producers who stay in the United States are not treated as well as actors. All of an actor's earnings qualify for the maximum 50 percent tax rate on earned income, whereas most of a producer's earnings can be taxed at rates up to 70 percent.[8]

Conclusion

To us it is clear that there is no constitutional point here. The entertainer provision in Article 17 is the internationally accepted one, with the United States alone in demanding a dollar threshold before tax may be imposed. Also, the Senate has recently approved similar entertainer provisions in treaties with Japan (1972), Iceland (1975), Trinidad & Tobago (1970), Romania (1976), and Belgium (1972).

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[1] This position is reflected in the provisions of the Model Treaty of the Organization for Economic Cooperation and Development.
[2] Article 8 of the proposed treaty.
[3] Article 20 of the proposed treaty.
[4] Article 19 of the proposed treaty.
[5] Sections 6073(b) and 6654(b), Internal Revenue Code.
[6] Section 1235, Internal Revenue Code.
[7] Section 912, Internal Revenue Code.
[8] This occurs when capital is a material income-producing factor in the producer's business. Treasury Regulations Section 1.1348–3.

PART III.—ESTIMATE OF TAX REVENUE IMPACT OF ACT AND PRT PROVISIONS

Advance Corporation Tax

It is difficult to estimate the tax revenue impact of the Advance Corporation Tax (ACT) provisions in the treaty, in view of the number of variables involved. Any estimate must take account of not only the dollar amount of ACT refunds made available under the treaty, and the U.K. withholding tax which the treaty sanctions, but the effective rate of U.K. corporate tax, the average tax rate of U.S. shareholders in the U.K., and the utility of excess foreign tax credits to U.S. investors. Our best estimate is that the additional U.S. tax on refunds of ACT under the treaty will be approximately offset by the U.S. foreign tax credit for additional U.K. withholding tax. The revenue effect to the U.S. Treasury will be minimal. The diminution in U.K. taxes achieved by means of the ACT provisions will go to the benefit of U.S. investors in the U.K.

Petroleum Revenue Tax

It is not possible to make an estimate of the revenue loss attributable to the treaty provisions relating to the petroleum revenue tax (PRT) although some information bearing on this is available.

First, the amount of PRT paid will depend to a large extent on the amount of oil extracted within the PRT jurisdiction. In March of 1975 the United Kingdom estimated that for the period 1975 to 1980 total PRT paid would be between $1.5 billion and $2.3 billion. It estimated annual PRT during the 1980's to be between $1.3 billion and $2.1 billion.

Second, even if the above estimates are correct, we have no information as to what extent the companies paying PRT are subject to United States tax jurisdiction.

Third, it is conceivable that the courts could hold PRT to be creditable independent of the tax treaty. In that case the treaty provision would not cause any revenue loss.

Fourth, under current law the amount actually credited against United States tax would depend upon the amount of dividends repatriated from United Kingdom corporations to United States corporate shareholders.

Fifth, even if the amounts claimed as credits against U.S. tax could be determined, there still remains the issue as to the extent to which PRT credits will actually offset U.S. tax. That is, oil companies are in an excess credit position; they have paid more non-PRT creditable taxes than they are permitted to credit. Data available for 1972 indicate that petroleum extracting companies has excess foreign tax credits of $1.2 billion, and petroleum refining companies has excess foreign credits of $2.6 billion.

Finally, even if the PRT were not creditable, it would be deductible from the amount of dividends otherwise considered distributed. Thus, the revenue cost of a deduction rather than a credit would be 52 percent of the PRT attributable to the dividend.

EXHIBIT 1

INTERNAL REVENUE SERVICE MEMORANDUM, AUGUST 4, 1977

To: Laurence N. Woodworth, Assistant Secretary for Tax Policy.
From: Jerome Kurtz, Commissioner of Internal Revenue.
Subject: Operation of Section 482 (Your Memorandum Dated July 22, 1977).

This memorandum responds to your request for an explanation regarding the operation of Section 482. It is my understanding that this memorandum is to be sent to Senator Church for inclusion in the record of recent hearings before the Senate Foreign Relations Committee regarding the proposed tax treaty with the United Kingdom.

As you know, IRC 482 and its regulations are designed to place controlled affiliates (foreign and domestic) on a tax parity with an uncontrolled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer.

The arm's-length standard has been held to be reasonable and has provided a common basis for understanding between different governments with which we have tax treaties. It has long served the IRS as its principal tool in combating abusive pricing practices.

Present regulations provide three methods for determining an arm's-length price on transfers of tangible property. In order of priority they are the com-

parable uncontrolled price method, the resale price method, and the cost-plus method. Under the regulations other unspecified methods can be used for determining arm's-length price only if none of the specified methods may reasonably be applied.

The use of any other method, however, still requires that the resultant conclusion is reasonable in light of the arm's-length standard. That is, economic realities were considered and it can be reasonably assumed that uncontrolled parties would have agreed to the conclusions.

The Service feels that even when there are no comparable uncontrolled sales, the 482 regulations are applied to reach satisfactory results. The Service does not use or contemplate a unitary system as the results would not reflect a reasonable arm's-length standard or acceptable accounting standards and practices. We feel that we are adequately combating abuse through the use of the arm's-length standard.

In a study released on January 8, 1973, Treasury and IRS analyzed 871 cases involving U.S. companies and foregin subsidiaries in which the examining revenue agent considered or made an adjustment in the allocation of income or deductions between the companies that would have increased the U.S. companies' income tax liability.

Of the 174 pricing adjustments made in the study, 20.7 percent were based on comparable uncontrolled price method, 10.9 percent were based on the resale price method, 27.6 percent were based on the cost-plus method, and 40.8 percent were based on another allowable method which was required to be used because of the unique features and/or industry practices. Where a pricing adjustment was considered but not made, however, the comparable uncontrolled price method was applied in 56.1 percent of the cases (234 cases out of 417) usually on the basis of evidence of sales to third parties offered by the taxpayer. Another method was applied in 27.6 percent of the cases in which a pricing adjustment was not made (115 out of 471 cases). See pages 11, 17 and 23 of enclosed Treasury Issues Study on Administration of Tax Rules Governing Related-Company Transactions.

As in any other case, taxpayers must pay interest on underpayments of tax. This applies to IRC 482 adjustments that are assessed under the provisions of the Code. There is no possibility that the taxpayer will receive an interest free loan as the interest due on the deficiency is computed from the filing date of the return. IRC 6621 provides for an adjustment of the interest rate to reflect current economic conditions as to the rate to be charged.

Attachment.

EXHIBIT 2

Hon. JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

Attn: John Rosenbaum.

DEAR SENATOR JAVITS: This is in reply to a letter from your office dated January 3, 1977, requesting the views of the Department of the Treasury on objections which have been raised to the provisions concerning entertainers and athletes in the proposed income tax treaties with the Republic of the Philippines and the United Kingdom. We have set forth below summaries of the relevant treaty provisions, their background and Treasury's views with respect to these provisions.

The Entertainer and Athlete Articles

Article 17 of the proposed treaty between the United States and the United Kingdom provides that the income derived by entertainers and athletes from their personal activities may be taxed in the contracting state in which their activities are exercised. An exception is provided where the amount of gross receipts derived by the entertainer or athlete does not exceed $15,000 United States dollars. In situations where income attributable to the activities of the entertainer is initially received by another person and the entertainer or athlete participates directly or indirectly in the profits of such other person, then such income is viewed as the income of the entertainer and taxable in the country where the activities are performed.

Article 17 of the proposed treaty with the Republic of the Philippines is substantially similar to the United Kingdom article and also allows the country of

source to impose a tax. However, that tax may be imposed only to the extent that the income exceeds $100 U.S. dollars per day or exceeds in the aggregate $3,000 U.S. dollars per year.

The Objections Raised

We assume that objections are being raised because these treaties place a dollar limitation on the amount of income earned by entertainers and athletes which will be exempt in the country of the source of such income. In comparison, these treaties provide more favorable treatment to income earned by others from the performance of personal services. In both treaties, income derived from the performance of personal services in a dependent capacity is exempt from tax in the country of source without any dollar limitation. Income from the performance of personal services in an independent capacity is exempt in the country of source without limitation in the case of the treaty with the United Kingdom; in the case of the treaty with the Philippines, this exemption has a dollar limitation but the dollar limitation is higher than that provided in the Philippine article on entertainers and athletes.

We also assume that, in the case of the proposed treaty of the United Kingdom, there is some concern with regard to the high rates of tax which are in effect in the United Kingdom.

The Views of the O.E.C.D. and U.S. Treaty Partners

It has been Treasury's experience that most countries enter into tax treaties with the view that the taxation of entertainers and athletes presents special problems and that the solution to these problems is to exclude entertainers and athletes from the personal services articles of treaties. As a result, their income is taxed in the country of source.

The Organization for Economic Cooperation and Development has taken a position on this issue in Article 17(Artistes and Athletes) of their model income tax convention. That article excludes entertainers and athletes from the coverage of the articles on dependent and independent services and provides that they may be taxed in the country of the source of their income. The O.E.C.D. commentary explains that Article 17 makes it possible to avoid the practical difficulties which often arise in taxing entertainers and athletes performing abroad.

Thus, the current international standard is to treat entertainers and athletes much more harshly than would be done by the proposed United Kingdom and Philippine treaties.

The Views of the Treasury

The Treasury is concerned about the tax treatment of entertainers and athletes in conventions. We disagree with the view of the O.E.C.D. model, which is the starting point for most treaty negotiations worldwide, and the position of many of our treaty partners, that there should be no exemption in the country of source for United States entertainers and athletes (and for foreign entertainers and athletes performing here).

The Treasury takes the position that entertainers and athletes should be treated as others performing services; i.e., they should receive a reasonable exemption from tax in the country of source. However, we recognize that entertainers and athletes often are not in the same circumstances as others performing personal services. In many situations entertainers and, to some extent, athletes receive very large sums (out of proportion to what an employee or self-employed profesional would ordinarily receive) for brief visits. We also recognize that the prevailing view outside of the United States is that there be no exemption at all in the country of source. Accordingly, while we insist that entertainers and athletes receive a reasonable exemption in the country of source, we believe that it is proper to place a limit on this exemption. However, we wish to emphasize that, as in the treaties with the Philippines and the United Kingdom, this limitation amounts comparable to ordinary standards of remuneration will be protected. It limited exemption they in effect will be in a preferred position in countries with which we have a treaty vis-a-vis other foreign entertainers for whom the treaty rule is typically that of the O.E.C.D. model (taxation where the services are performed without exception). Finally, an additional element in the Treasury position is that we believe that our conventions should contain provisions to deal effectively with devices employed by foreign entertainers to avoid United States tax (these devices are explained below).

Entertainer Provisions in Other United States Conventions

The proposed treaties with the United Kingdom and the Philippines are not the first or the only United States conventions to provide that entertainers and athletes have a limited exemption in the country of source. For example, our treaties with Japan (entered into force on July 9, 1972), Iceland (entered into force on December 26, 1975), Trinidad and Tobago (entered into force on December 30, 1970), Romania (entered into force on January 26, 1976) and Belgium (entered into force on September 13, 1972) all contain provisions which limit the exemption of entertainers in the country of source. The limitations in these treaties with respect to entertainers and athletes apply either to dependent or independent services or to both.

The draft United States Model Income Tax Convention, which was published May 18, 1976, also adopts the position of limited exemption in the country of source for entertainers and athletes. In fact, that Model contains, in Article 17 (Artistes and Athletes) provisions which are identical to those in the proposed treaty with the United Kingdom. The United States Model, which is similar in many other respects to the O.E.C.D. model, is our starting point in treaty negotiations with other countries.

Foreign Entertainers Avoiding U.S. Tax

It is stated above that Treasury believes that our conventions should contain provisions to deal effectively with devices employed by foreign entertainers to avoid United States tax. This statement requires some explanation.

It has been the experience of the United States that some foreign entertainers and athletes employ contrived business arrangements in the context of tax treaties to avoid United States tax on income earned for their performances here. In fact, the tax treaty currently in effect between the United States and the United Kingdom has been the subject of such avoidance schemes. That treaty provides, in Article XI(1), that an individual who is a resident of the United Kingdom shall be exempt from tax in the United States on compensation for personal services performed in the United States if he is present here for no more than 183 days in the taxable year and performs his services on behalf of a person resident in the United Kingdom (i.e., performs these services in connection with an employment relationship).

One example of an avoidance technique attempted under this treaty provision is where an entertainer organizes a corporation in the United Kingdom and becomes its sole shareholder and "employee". A contract is entered into between the corporation and the "employee" to give the latter complete control over the details of his work. The payment made by the U.S. promoter for a performance by the entertainer in the United States is characterized by the entertainer, in part, as compensation for his services. The remainder is characterized as a fee to the corporation in consideration for the loan of the employee-entertainer to the U.S. or other person promoting the entertainment event. As the sole shareholder of the corporation receiving the compensation for the entertainer's performance, the entertainer subsequently receives the so-called loan-out fee as a dividend.

The purpose of such an arrangement is to obtain the exemption from tax at source provided by Article XI(1) to an employe of a corporation. Additionally, the fee paid to the United Kingdom corporation is not taxable in the United States if the foreign corporation does not have a permanent establishment in the United States. In Revenue Ruling E4–330, 174–2 C.B. 278, the Internal Revenue Service took the position that under circumstances such as those explained above where, among other things, the entertainer retains control over the details of his work, an employer-employee relationship does not exist. Consequently, none of the income attributable to the performance of the entertainer's services qualifies for treaty exemption.

There also have been more complicated schemes under the current United States-United Kingdom Treaty such as double loan-out arrangements involving corporations organized in the Channel Islands of the United Kingdom. These arrangements are analyzed in Revenue Ruling 74–331, found at 1974–2 C.B. 281. It is our understanding that the Internal Revenue Service has docketed and settled cases involving facts which parallel those found in Revenue Rulings 74–330 and 74–331.

Solution to the Avoidance Problem

As a result of experiences such as those just mentioned, the United States and the O.E.C.D. have both taken the position that where income in respect of the

performance of an entertainer or athlete is not paid to the entertainer or athlete but diverted to another person, such as a so-called artise company, such income should be taxable in the country of source where, for instance, the entertainer has control over or rights to the income thus diverted. This position is reflected in paragraph 2 of Article 17 in the U.S. Model, the O.E.C.D. Model, and the proposed treaties with the United Kingdom and the Philippines. It is hoped that this provision will prevent future avoidance of United States tax by foreign entertainers. It should be noted that a more general provision with the same effect is contained in the current treaty with Iceland. See Article 20 (Amounts Received for Furnishing Personal Services) of the Iceland treaty.

Tax Rates in the United Kingdom

It was mentioned above that United States entertainers and athletes may be concerned that Article 17 of the proposed convention with the United Kingdom will subject them to very high rates of tax in the United Kingdom on the income they earn there. It is well known that rates of tax in the United Kingdom go as high as 83 percent in the case of personal service income. However, U.S. entertainers and athletes may not be aware that under United Kingdom law there is relief (i.e., a deduction) available which substantially reduces the rate of United Kingdom tax. To be specific, United Kingdom law provides that if individuals who are not British domiciliaries work for companies which are not United Kingdom residents, their earnings constitute "foreign emoluments." In the case of those foreign emoluments, a deduction is give of 50 percent of the emoluments. In other words, the maximum marginal rate of tax on the personal services income of a U.S. entertainer or athlete working in the United Kingdom as an employee of a U.S. corporation (not managed and controlled in the United Kingdom) is approximately 42 percent. However, if a U.S. entertainer or athlete becomes domiciled in the United Kingdom or is resident of the United Kingdom for nine out of ten years of assessment, then the deduction for foreign emoluments is eliminated and reduced to 25 percent, respectively.

No Double Taxation

We wish to point out that U.S. entertainers and athletes are certainly protected against double taxation under the proposed treaties with the Philippines and the United Kingdom. It is important to understand that permitting the source country to impose a tax does not constitute double taxation. Rather, the United States tax is reduced dollar for dollar by the tax paid to the country of source through the foreign tax credit.

Conclusion

In conclusion, it is the view of the Treasury that the articles concerning entertainers and athletes in the proposed treaties with the United Kingdom and the Republic of the Philippines are fair and reasonable. They provide an exemption for the income of entertainers, up to certain amounts, and protect the entertainers from double taxation. While the exemption is limited, the limit is high enough to cover amounts comparable to ordinary standards of remuneration. These articles (and the U.S. Model) represent a viable response to demands of other countries that entertainers and athletes receive no exemption at all in the country of source. In addition, these provisions justifiably reflect the fact that some foreign entertainers and athletes have, in the past, employed contrived tax avoidance arrangements directed at the U.S. income tax.

If I can be of any further assistance to you on this matter, please let me know.

Sincerely yours,

LAURENCE N. WOODWORTH.

CONTROLLER OF THE STATE OF CALIFORNIA,
Sacramento, Calif., September 9, 1977.

Hon. FRANK CHURCH,
Chairman, Subcommittee on Foreign Economic Policy, Committee on Foreign Relations, U.S. Senate, Washington, D.C.

DEAR SENATOR CHURCH: Attached are copies of my observations on the U.S. Treasury's response to my oral and written testimony before the Senate Foreign Relations Committee regarding the United States-United Kingdom Treaty.

Cordially,

KENNETH CORY.

Enclosures.

OBSERVATIONS ON THE U.S. TREASURY'S RESPONSE TO MR. KENNETH CORY'S ORAL AND WRITTEN TESTIMONY

Item 1

Mr. Cory states that this treaty is a fundamental attack on California's historic unitary tax system. In fact, it applies only to a small par of the unitary system, the portion dealing only with foreign-owned operations, a portion adopted by an administrative practice instituted by California within the last five years.

Observation.—The response does not identify where Mr. Cory stated that the Treaty is a fundamental attack on California's historic unitary tax system. This, however, is the case, and was made clear by the witnesses which followed and by proposals which Treaty advocates have backed in the California Legislature.

Mr. Andrew W. Gotelli of Peat, Marwick, Mitchell and Company, on behalf of California Council for International Trade, San Francisco, California, stated:

"California is indisputably the nation's gateway to the Pacific Basin. While adoption of the instant tax convention with the UK might not directly affect our lucrative business with the Pacific, we believe a number of legal considerations would have a salutary result, upon adoption of the treaty, of prohibiting imposition of the unitary method of combined reporting upon California subsidiaries of companies domiciled in all foreign nations. To be sure, investment in California by United Kingdom enterprises is not inconsequential."

Mr. William D. McKee appeared on behalf of fourteen foreign banks located in Mexico, Canada, Japan, France, West Germany and Hong Kong. He stated in part, " . . . These banks are not directly covered by the treaty, but they believe that if Article 9(4) is adopted similar protection will ultimately be extended to them. . . ."

It is also noted that Mr. Ernest S. Christian, Jr., appeared on behalf of the Committee on State Taxation, Council of State Chambers of Commerce and supported the Treaty. The Committee of State Taxation consists of approximately one hundred U.S. corporations engaged in multistate business in the United States and international business abroad. It would be somewhat naive to conclude that this organization would support a provision in a Treaty which benefits only their United Kingdom-owned and based competitors.

Item 2

Mr. Cory's estimate of the revenue loss to the State of California is much overstated. His oral testimony states that the $125 million annual revenue loss to California was from the treaty "as originally presented." This, of course, is not the same provision. The Chief Counsel of the California Franchise Tax Board has publicly estimated the revenue cost to be less than one-sixth of Mr. Cory's estimate. Thus, the revenue loss is less than one-fifth of one percent of California's 1976 tax revenues.

Observation.—Mr. Cory's testimony, as well as the written statement made it clear that the $125 annual revenue loss was based on provisions of the U.S.–U.K. Treaty "as originally presented." The reason is that only one estimate has been prepared, and it was based on the provisions of the Treaty before it was revised.

Treasury Department representatives have stated that if this Treaty is approved, similar restrictions will be included upon request.

The Chief Counsel has not estimated the revenue loss under the revised Treaty. The department has only made one estimate, and that was based on provisions of the original Treaty. At a meeting where the Chief Counsel was the speaker and at which Mr. McKee was present, the Chief Counsel indicated that the loss from excluding foreign parents from a unitary computation might be in the $15 to $20 million range as had been suggested from the floor. The comment, however, was in response to an inquiry, and was not an estimate.

Item 3

Mr. Cory complains that California was not consulted. However, when his objection was made known, it was taken into account. Mr. Cory's testimony states that "[a]fter the Treasury Department was contacted by California, the treaty was revised. . . ."

Observation.—California was not consulted at any time by the Treasury Department. Representatives of the International Tax Division of the Treasury Department were called on occasions by representatives of the department after the Treaty was signed. While such Treasury Department representatives were

accessible and responsive, the calls were for the purpose of obtaining information from them. The initial contact, like the other calls, was for the purpose of obtaining information. When the first cal was made, the International Tax Division advised they were in the process of revising the Treaty so that it would apply only to U.K.-based and owned corporations. Accordingly, the Treaty was not revised as a result of consultation.

Item 4

Mr. Cory states that the treaty is an "end run" by American "special interests" around the domestic legislative process. In fact, the provision was requested by the British. It does not benefit United States-controlled companies.

Observation.—Mr. Cory has never been informed as to how Article 9(4) originated. His observations as to the "end run" are set forth on pages 2–51 through 2–53 of the transcript. As to the footnotes and further explanation of prior observations, the following is submitted:

Footnote 7

Notes that New York's unitary system is more limited than California's. Concluded that Mr. Cory equated the two.

Observation.—The paper is setting forth observations of Professor Schoettle, as published in Tax Notes, April 4, 1977, p. 3 at 8.

Footnote 8

Quotes an article to the effect that California did not apply a unitary computation to foreign subsidiaries until the 1960s.

Observation.—California applied the formula to foreign subsidiaries of United States corporations prior to 1960. Since the unitary concept is an evolutionary process, the first application is unknown. It most likely was applied to foreign subsidiaries sometime in the 1950s. See also the statement filed by William McKee, p. 4.

Footnote 9

Quotes the same article as in footnote 8 that California began including foreign-based corporations in unitary computations only in the last five years.

Observation.—This is not correct. California has applied the unitary concept to foreign-based corporations for more than the last five years. For example, the pending administrative appeal by the Hongkong Bank of California involves the years 1959 through 1966.

Footnote 10

Reflects irritation because Mr. Frank Keesling is referred to as a "noted commentator."

Observation.—Mr. Keesling has been a member of a major law firm for over thirty years. He is co-author of a most authoritative textbook entitled Allocation of Income in State Taxation, which has been cited on several occasions by the United States Supreme Court. He has also authored or co-authored numerous law review articles. It hardly seems that one should be irritated because Mr. Keesling was Counsel to the department over thiry years ago.

Footnote 13

Did not reflect Mr. Cory's written material as explained.

Observation.—This footnote does not reflect the written statement. The statement indicated that most-favored-nation clauses may automatically engraft (the Article 9(4)) language in such treaties. The footnote said that Mr. Cory asserted that most-favored-nation clauses will engraft Article 9(4) onto other treaties. For the arguments which it is anticipated will be advanced, see pages 2 and 3 of the Position Paper filed by Valentine Brookes. Part of his written remarks, which are based upon the holding of the California Supreme Court in 11, cert. den. 368 U.S. 899, follow:

Scandinavian Airlines Systems, Inc., v. *County of Los Angeles*, (1961) 56 Cal. 2d

"It concluded also that in spite of the lack of parallel provisions in the Norwegian and Danish income tax treaties with the United States, those countries were entitled to the benefits of a most favored nation clause it found in each of their treaties, and hence they enjoyed the same exemptions for their airplanes which the Swedish airplane was found to enjoy. The Court went further and

held, as an alternative ground (14 Cal. Rptr. at 43) that federal constitutional provisions prevented California from discriminating between foreign nations, and therefore it must accord each nation the favored treatment the Swedish treaty provided for the Swedish property."

Further Discussion of Item 4

The concluding discussion in Item 4 is directed toward the United States-United Kingdom Treaty and its effect on states generally and California in particular and that the Treaty is not an "end run."

Observation.—This discussion has not taken into account the uneven tax treatment of U.S. and foreign-based corporations which will be mandated if the Treaty is approved. It seems obvious that if the Treaty is approved, and is expanded to other countries, that powerful arguments will be made that the states should not continue to use one method for determining income of U.S.-based corporations and another method for foreign-based corporations. Legislation to prohibit California from including any operations outside the United States has already been introduced and is before the California Legislature (SB–855 and SB–1266). However, it is unlikely that if the Treaty had not been negotiated that such legislation would have been introduced.

As to Mr. Cory's observations that the Senate Foreign Relations Committee is not the proper forum to resolve the issues involved in Article 9(4), the Honorable Al Ullman, Chairman, Committee on Ways and Means, was of a similar view. As the record shows, he forwarded a letter dated July 18, 1977, to the Honorable John Sparkman, Chairman, Senate Foreign Relations Committee, which stated in part:

"It is my belief that if the Federal Government is to place any limitations on the use of combined reporting by State or local taxing authorities, the limitations should be imposed through the regular manner by legislation and not through bilateral tax treaties. The legislative process would give both Houses of Congress the opportunity to hear and consider fully all sides of the issues involved. Moreover, the issues could be considered on their own merits, rather than determined as a *quid pro quo* for concessions made by a foreign government, which concessions do not benefit the States and localities whose taxing jurisdictions are being limited by this negotiated package. Finally, the legislative process would permit uniform rules to be applied to all taxpayers, U.S. and foreign. . . ."

Conclusion

The conclusion compares the gain to U.S. investors under provisions of the Treaty against the revenue loss which the states would suffer.

Observation.—The response states that the refund of ACT payments are estimated at $125 million annually and $400 million for past years. Mr. Woodworth's oral testimony of July 20, 1977 (2–21) was that the refund for past years (1973–76?) would be $178 million. It appears that the gain to U.S. investors is substantially overstated and the Committee should request reconciliation of these estimates.

The conclusion also substantially understates what is at stake from the states' viewpoint. The stakes are not simply the approval of this unprecedented direct restriction on state taxing powers via a treaty. The stakes are much greater. Aside from overriding state taxing powers, the Senate Foreign Relations Committe is opening the door for a continuing oversight of state tax policy through the treaty process.

Furthermore, favorable actions on the Treaty requires states to apply one method for determining income for United Kingdom-based corporation, most likely all foreign corporations as new treaties are negotiated, and a different method for U.S.-based corporations. Obviously, a dual standard is on a shaky foundation. What is most likely is that the unitary concept will collapse. If this occurs, the cumulative loss of state tax revenue will be immense, and such loss will benefit only the multistate and multinational corporations which are urging approval of the United States-United of Kingdom Treaty so that they may get their foot in the door.

Senator CHURCH. I think that will conclude the hearing this morning.

[Whereupon, at 1:10 p.m. the committee adjourned subject to the call of the Chair.]

94–802—77——21

APPENDIX

[From the Los Angeles Times July 15, 1977]

BROWN ASKS CHANGES IN BUSINESS TAX—REVISIONS COULD BRING AUTO, ELECTRONICS PLANTS TO STATE

(By Jerry Gillam, Times staff writer)

SACRAMENTO—The Brown Administration asked the state Franchise Tax Board Tuesday to consider exempting some multinational business operations from a tax method that allegedly discourages business expansion in California.

Business and Transportation Agency Secretary Richard T. Silberman said such a move would encourage Japanese automobile and electronics industries to set up manufacturing plants here, with a resulting increase in jobs.

Gov. Brown who is up for reelection next year, has been advocating such moves in recent months to help counter critics who charge that his Administration has created a poor business climate.

The Republicans are expected to zero in on the business climate as a 1978 campaign issue. Brown would like nothing better than to have several Japanese firms move to the Golden State before election time.

The governor went to Japan in April and found that businessmen there did not like the "unitary" method of taxing multinational and international corporations.

Under this method, the state examines a corporation's world-wide sales, property and payroll, determines the percentage attributable to California and taxes accordingly.

Only two U.S. states—California and Oregon—use this method.

Under the more common "arms-length" method, a corporation's business in a state is treated and taxed as a separate entity, without taking into consideration its worldwide operations.

Brown had supported the "unitary" tax method until he visited Japan and heard the complaints.

Specifically, Silberman asked the Franchise Tax Board, headed by Controller Kenneth Cory, to do three things:

Consider eliminating the application of the unitary tax method to foreign operations, except for oil companies.

Issue advance rulings so that foreign firms who want to come to California can know beforehand what their tax liability might be here.

Make it clear that it is willing to look at any particular situation in which the unitary tax method may be unfair and make adjustments as appropriate.

Cory said, "We will listen to all of the testimony. If it makes sense, we may change the regulations."

More than 1,000 multinationals and interstate corporations were invited to air their grievances against unitary taxation at Tuesday's day-long hearing, attended by a standing-room-only crowd.

Among those accepting the invitation was Ronald J. Joranko, a spokesman for TRW, Inc., an Ohio corporation with substantial investments in California.

We oppose the worldwide unitary method of computing the California franchise tax liability because this method taxes unrepatriated earnings of our foreign operations and subjects such income to tax far beyond that provided for by federal statutes," Joranko said.

"We further oppose the unitary method of computing taxable income since our foreign operations do not derive their source of income, or any related economic function, within the territorial jurisdiction of the state of California.

Atty. William D. McKee, representing the Hong Kong Bank of California, put it even more bluntly.

"The Hong Kong Bank will move from California unless its franchise tax problems are resolved," McKee told the board.

TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL GAINS SIGNED AT LONDON, ON DECEMBER 31, 1975, AS AMENDED BY THE NOTES EXCHANGED AT LONDON ON APRIL 13, 1976, THE PROTOCOL SIGNED AT LONDON ON AUGUST 26, 1976, AND THE SECOND PROTOCOL SIGNED AT LONDON ON MARCH 31, 1977

ARTICLE 1. PERSONAL SCOPE

This Article delineates the persons who come within the scope of the Convention. Paragraph (1) states the general rule that the Convention is applicable to residents of one or both of the Contracting States. The term "resident" of a Contracting State is defined in Article 4 (Fiscal Residence). In several cases, the Convention is also applicable to residents of third states because of their relationship with a resident of a Contracting State. For example, Articles 9 (Associated Enterprises), 25 (Mutual Agreement Procedure) or 26 (Exchange of Information and Administrative Assistance), may apply with respect to persons who are residents of neither Contracting State, and paragraph 5 of Article 10 (Dividends) and paragraph 6 of Article 11 (Interest) apply to dividends and interest derived by residents of third countries.

This paragraph is similar to Article 1 of the Draft Double Taxation Convention on Income and Capital developed by the Fiscal Committee of the Organization for Economic Cooperation and Development as published in 1963 and as thereafter revised (hereinafter referred to as the "OECD Model Convention").

Paragraph (2) deals with the treatment of a corporation which is a resident of both the United Kingdom within the meaning of paragraph (1)(a)(ii) of Article 4 (Fiscal Residence) and the United States (under paragraph (1)(b)(ii) of Article 4). Under those paragraphs, a corporation which is a United States corporation as defined by paragraph (1)(b) of Article 3 (General Definitions) and is managed and controlled in the United Kingdom would be a resident of both states. This Article clarifies the status of such corporations (hereinafter referred to as "dual-resident" corporations) for purposes of the Convention by providing that dual-resident corporations may not claim the benefits of this Convention which are otherwise available to residents of a Contracting State, including the benefits of Articles 7 (Business Profits), 10 (Dividends), 11 (Interest), 12 (Royalties), 22 (Other Income) or 23 (Elimination of Double Taxation). However, a dual-resident corporation may claim the benefits of paragraph (2) of Article 8 (Shipping and Air Transport) with respect to profits derived from operating ships or aircraft, and of Article 23 (Elimination of Double Taxation) with respect to paragraph 1(c) thereof and with respect to payments of the United Kingdom petroleum revenue tax. A dual-resident corporation may also claim the benefits of Articles 24 (Non-discrimination), and 28 (Entry Into Force), and the provisions of paragraph (7) of Article 11 (Interest) relating to the character of certain interest payments will apply to it. Thus, for example, a dual-resident corporation may not claim the exemption from tax with respect to interest derived from the United States under Article 11 (Interest) or claim a refund of advance corporation tax with respect to a dividend received from a corporation which is a resident of the United Kingdom. In these cases, the dual-resident corporation is treated as a resident of neither Contracting State for purposes of the Convention.

On the other hand, interest, royalties, and dividends derived by a resident of a Contracting State from a dual-resident corporation will qualify for the exemptions or reductions in tax allowed by the Convention. For example, dividends received by a resident of the United Kingdom from a dual-resident corporation will qualify for the reductions in United States tax withholding under paragraph (1) of Article 10 (Dividends) and, a United States resident receiving dividends from a dual-resident corporation which, under the internal law of the United Kingdom, is a resident of the United Kingdom, will qualify for the refunds or credits of advance corporation tax under paragraph (2) of that Article.

Paragraph (3) contains the traditional "saving clause" under which each Contracting State reserves the right to tax its nationals (as defined by paragraph (1)(k) of Article 3 (General Definitions)) and residents (as determined

under Article 4 (Fiscal Residence)) as if the Convention had not come into effect. A similar provision exists in Article XIII of the Convention now in effect (hereinafter referred to as the "1945 Convention"). The saving clause is of principal importance to the United States because the United States taxes its citizens, residents, and corporations on a worldwide basis, regardless of where they reside or derive income.

Paragraph (4) sets forth certain exceptions to the application of the saving clause where other provisions of the Convention reflect overriding policies. Thus, the saving clause does not affect the provisions dealing with the determination of domicile for United Kingdom tax purposes (paragraph (4) of Article 4), the exemption from United Kingdom tax of profits derived by United States nationals and corporations from operating ships or aircraft (paragraph (2) of Article 8), associated enterprises (Article 9), the elimination of double taxation (Article 23), non-discrimination (Article 24) or the mutual agreement procedure (Article 25). Moreover, the saving clause does not affect benefits of the Convention which are extended to an individual performing functions as an employee of a government of a Contracting State, as a teacher, as a student or trainee, or as diplomatic and consular official, who is neither a national (as defined in Article 3) of, nor has immigrant status in, the Contracting State imposing the tax. See Articles 19 (Government Service), 20 (Teachers), 21 (Students and Trainees), and 27 (Effect on Diplomatic and Consular Officials and Domestic Laws). In the case of the United States, "immigrant status" means the individual has been admitted to the United States for permanent residence.

Although Article 1 is entitled "Personal Scope", the Convention is applicable to corporations and other persons as well as to individuals.

ARTICLE 2. TAXES COVERED

Paragraph (1) of this Article states the general rule that the Convention applies to taxes on income imposed by the governments of the Contracting States. The Convention also applies to taxes on income imposed by political subdivisions or local authorities of a Contracting State (as defined in paragraph (1)(i) of Article 3 (General Definitions)) where paragraph (4) of Article 9 (Associated Enterprises) applies. This Article is important because the relief from double taxation (i.e., tax credits) accorded to Article 23 (Elimination of Double Taxation) only extends to taxes covered by this Convention. Thus, credits for taxes paid to a Contracting State may be claimed under this Convention only with respect to the taxes specified in paragraphs (2) and (3) of this Article.

Paragraph (2) designates the existing taxes on income which are the subject of the Convention. In the case of the United States, the taxes on income included (referred to as "United States tax") are the Federal income taxes imposed by the Internal Revenue Code ("Code") and the tax under Code section 4371 on insurance company premiums paid to foreign insurers. The tax under Code section 4371 is not covered by the 1945 Convention. The Convention also applies to taxes imposed under section 1401 (tax on self-employment income) and under sections 3101 and 3111 (Federal Insurance Contributions Act taxes) with respect to the employee's share of the tax. The employer's share of the tax is not regarded as an income tax and, accordingly, it is not covered by this paragraph. The Convention only applies to taxes on income contained in the Internal Revenue Code. Thus, the Convention does not, for example, apply to the excise tax under Code section 1491.

The Convention also does not apply to the taxes imposed under Code sections 531 (Accumulated Earnings Tax) or 541 (Personal Holding Company Tax), except as specified by paragraph (6) of Article 10 (Dividends). Under paragraph (6) of Article 10, a corporation which is a resident of the United Kingdom shall be exempt from the accumulated earnings or personal holding company tax if individuals (other than nationals of the United States) who are residents of the United Kingdom control, directly or indirectly, more than 50 percent of the voting power of such corporation.

In the case of the United Kingdom, paragraph (2) provides that the existing taxes on income covered by the Convention (referred to as "United Kingdom tax") are the income tax, the capital gains tax, the corporation tax, and the petroleum revenue tax.

For purposes of paragraph (4) of Article 9 (Associated Enterprises), this Convention also applies to taxes imposed on income by political subdivisions or local authorities of a Contracting State. For this purpose, the income taxes referred to include any franchise taxes measured by income which are imposed by a political subdivision or local authority of a Contracting State.

Under paragraph (3), the Convention will also apply to taxes substantially similar to those covered by paragraph (2), which are imposed in addition to, or in place of, the taxes referred to in paragraph (2) after the date of signature of the Convention (December 31, 1975).

The competent authorities of the Contracting States are to notify each other of any amendments of the laws imposing the existing taxes and of the adoption of any taxes which are imposed subsequent to the date of signature of the Convention.

For purposes of Article 24 (Non-discriminaton), the Convention will also apply to taxes of every kind and description (whether or not the taxes are of income) imposed by the Contracting States, political subdivisions or local authorities thereof.

ARTICLE 3. GENERAL DEFINITIONS

Paragraph (1) defines the principal terms used throughout the Convention. Unless the context otherwise requires, the terms defined in this paragraph shall have a uniform meaning throughout the Convention. It should be noted that a number of important terms are defined elsewhere in the Convention. For example, the term "resident" of a Contracting State and "permanent establishment" are defined in Articles 4 (Fiscal Residence) and 5 (Permanent Establishment), respectively. Moreover, certain terms which appear in Articles dealing with special categories of income, e.g., "Immovable Property" (Article 6), "Dividends" (Article 10), "Interest" (Article 11), and "Royalties" (Article 12), are defined within those Articles.

The Article defines the term "corporation" in subparagraph (a) as a United States corporation (defined in subparagraph (b)(i)) or a United Kingdom corporation (defined in subparagraph (b)(ii)), or any body corporate or entity of a third state which is treated as a body corpororate for tax purposes by both Contracting States. Whether an entity is a corporation is relevant for purposes of paragraph (6) of Article 5 (Permanent Establishment), Article 10 (Dividends), Article 16 (Investment or holding companies), and Article 23 (Elimination of Double Taxation).

The term "United States corporation" means a corporation (or any unincorporated entity which is treated as a United States corporation for United States, any state thereof, or the District of Columbia.

A "United Kingdom corporation" is defined as any body corporate or unincorporated association created or organized under the laws of the United Kingdom, excluding for this purpose a partnership, a local authority, or a local authority association.

Whether a United States or United Kingdom corporation or any other corporation is a resident of a Contracting State for purposes of this Convention, or neither of them, or both of them, is to be determined in accordance with Article 4 (Fiscal Residence).

The term "person" includes an individual, a corporation, a partnership, an estate, a trust, or any other body of persons.

The term "enterprise of a Contracting State" means an industrial or commercial undertaking carried on by a resident of a Contracting State (as defined by Article 4).

The term "international traffic" is defined as any transport by a ship or aircraft operated by an enterprise of one of the Contracting States, except when the ship or aircraft is operated solely between places within a Contracting State. Thus, for example, coastal shipping along the Atlantic coast of the United States is not international traffic. However, if a ship operated by an enterprise of the United Kingdom transports goods from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the portion of the transport between New York and Norfolk is international traffic. The definition of this term is relevant for purposes of Article 8 (Shipping and Air Transport) which provides that profits derived by an enterprise of a Contracting State from the operation in international traffic of ships or aircraft shall be taxable only in that State.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to the United Kingdom, the term "competent authority" refers to the Commissioners of Inland Revenue or their authorized representative.

The term "United States" means the United States of America. When used in the geographical sense, the term means the states thereof and the District of Columbia. Thus, the Convention does not apply to possessions of the United States or the Commonwealth of Puerto Rico. The term "United States" also includes the territorial sea and, in general accord with the principles of section 638 of the Code, the continental shelf of the United States.

The term "United Kingdom" means Great Britain and Northern Ireland, including the area of the continental shelf which has or may be designated by the United Kingdom, in accordance with international law, as an area within which the rights of the United Kingdom relating to the seabed and subsoil and their natural resources may be exercised. The Convention does not apply to the Channel Islands or the Isle of Man.

The 1945 Convention does not include the continental shelf areas in the definition of the terms United States or United Kingdom. It is understood that when compared to the 1945 Convention, the United Kingdom regards the reference to its continental shelf in this Convention as an expansion of the scope of the Convention with respect to operations in these areas.

The term "Contracting State" means the United States or the United Kingdom, as the context of the Convention requires.

The term "third State" means any State or territory other than the United States or the United Kingdom and the term "enterprise of a third State" is to be construed accordingly.

In relation to the United States, the term "national" means an individual who is a citizen of the United States. In relation to the United Kingdom, the term "national" means all citizens of the United Kingdom and colonies, British subjects under sections 2, 13(1) or 16 of the British Nationality Act of 1948, and British subjects by virtue of section 1 of the British Nationality Act of 1965, provided they are patrial within the meaning of the Immigration Act of 1971, so far as these provisions are in force on the date of entry into force of this Convention or have been modified in minor respects so as not to affect their general character.

Paragraph (2) provides that any term used in the Convention which is not defined therein shall, unless the context otherwise requires or unless the competent authorities agree to a definition of the term pursuant to Article 25 (Mutual Agreement Procedure), have the meaning which it has under the laws of the Contracting State where a tax is being determined. Under Article 25, where a term which is not defined in the Convention has a different meaning under the laws of the United Kingdom and the United States or where the meaning under the laws of one of the Contracting States is not readily determinable, the competent authorities may, for purposes of the Convention, establish a common meaning of the term in order to prevent double taxation or to further any other purpose of the Convention.

ARTICLE 4. FISCAL RESIDENCE

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. Residence is important because, except as otherwise provided in the Convention, only a resident may claim the benefits of the Convention.

The term "resident of the United Kingdom" is defined as a corporation (as defined in paragraph 1(a) of Article 3 (General Definitions)) whose business is managed and controlled in the United Kingdom, and any other person (except a corporation as defined in paragraph (1)(a) of Article 3), resident in the United Kingdom for purposes of its tax.

Similarly, the term "resident of the United States" is defined as a person (except a corporation as defined in paragraph (1)(a) of Article 3) who is resident in the United States for purposes of its tax. This includes a resident alien individual who is subject to tax in the United States on his worldwide income and a resident citizen. The term also includes a corporation (as defined in paragraph (1)(b)(i) of Article 3). A foreign corporation, regardless of the

extent to which its income is effectively connected with the conduct of a United States trade or business, is not a resident of the United States.

It should especially be noted that an individual is not automatically a resident of the United States or the United Kingdom for the purposes of this Convention if he is a citizen of either country. To be a resident of a Contracting State, he must be subject to tax in that State on account of his residence therein. In the case of the United States, an individual will be considered to be a resident if, without regard to his citizenship, he would be taxable in the United States on his worldwide income as a resident. Residence for this purpose is to be determined in accordance with the principles of Treasury regulations under section 871 of the Internal Revenue Code.

The definition of a resident of a Contracting State in the Convention differs from the definition of a resident in the 1945 Convention. Under paragraph (1)(g) of Article II, of the 1945 Convention a resident of the United Kingdom is defined, in pertinent part, as "any person (other than a citizen of the United States or a United States corporation) who is resident in the United Kingdom for purposes of United Kingdom tax . . ." and under paragraph (1)(h) of Article II a resident of the United States is defined, in pertinent part, as "any individual who is resident in the United States for the purposes of United States tax and not resident in the United Kingdom for the purposes of United Kingdom tax . . ." In the case of Strathalmond (Lord) v. Inland Revenue (Ch. D. June 23, 1972), a British court interpreted this definition, in applying Article XV of the 1945 Convention, to prevent the United Kingdom from taxing the United States source dividend income of a United States citizen residing in the United Kingdom. This result is inconsistent with the principles of the OECD Model Convention. Accordingly, under this Article, a United States citizen who resides in the United Kingdom for purposes of its tax will be taxable therein as a resident and, subject to the provisions of United Kingdom law, the United Kingdom will be permitted to tax those citizens on their dividend and interest income regardless of the source of that income. However, where the income of the United States citizen has a source in the United States (as determined under the laws of the United Kingdom) the United Kingdom will allow a credit against the United Kingdom tax for any United States tax payable (on the basis of that person's United States citizenship) with respect to that income. See the discussion of paragraph (3) of Article 23 (Elimination of Double Taxation).

A corporation which is a resident of both Contracting States under this Article (i.e., a United States corporation whose business is managed or controlled in the United Kingdom), is dealt with by paragraph (2) of Article 1 (Personal Scope), and such a corporation may not claim any benefit under this Convention except as provided therein.

Paragraph (1) of this Article also provides that a partnership, estate, or trust is a resident of a Contracting State only to the extent that the income derived by such person is subject to tax in such Contracting State as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the Convention, income received by a partnership, estate, or trust will be treated for purposes of the Convention as income received by a resident of the United States only to the extent such income is subject to tax in the United States as the income of a resident. Thus, for United States tax purposes, the question of whether income received by a partnership is received by a resident will be determined by the residence of its partners rather than by whether the partnership is resident in the United States by reason of engaging in a trade or business here. To the extent the partners are subject to United States tax as residents of the United States, the income received by a partnership will be treated as income received by a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

The fact that a charitable organization or pension fund is exempt from tax in the country in which it is otherwise resident is not to be construed to deny such organization or fund resident status under this Convention.

Paragraph (2) provides that an individual who is a resident of *both* Contracting States under paragraph (1) will, for purposes of the Convention, be deemed to be a resident of the Contracting State in which he has a permanent home available to him (e.g., where an individual dwells with his family), his

center of vital interests (e.g., close economic and personal relations), an habitual abode, or the State of which he is a national, in that order. If the issue cannot be settled by the application of these tests, the competent authorities shall decide by mutual agreement the one Contracting State of which he will be considered to be a resident. Thus, for purposes of the Convention, including paragraph 3 of Article 1 (Personal Scope) (the saving clause) an individual may be a resident of the United States or the United Kingdom, but not both.

Paragraph (3) provides that if an estate or trust (taxable as such) is a resident of both Contracting States under the provisions of paragraph (1), the competent authorities may settle the issue by mutual agreement.

Since the definitions of residence in this Article apply for purposes of the entire Convention, an individual who is deemed to be a resident of one Contracting State and not a resident of the other Contracting State by reason of paragraph (2) will be deemed to be a resident of the first-mentioned Contracting State for all purposes of the Convention. For example, if an individual is determined to be a resident of the United Kingdom under paragraph (2) but would apart from that paragraph also be considered a resident of the United States under the laws of the United States, such individual would continue to receive the exemptions and special benefits granted by the Convention to residents of the United Kingdom, unless the individual is a citizen of the United States (see the saving clause of paragraph (3) of Article 1 (Personal Scope)).

Paragraph (4) provides that for United Kingdom tax purposes the domicile, on or after April 6, 1976, of a woman who is a United States national and who was married before January 1, 1974 to a man domiciled in the United Kingdom will be determined as though such marriage had taken place on January 1, 1974. The foreign source income of a United Kingdom resident is subject to taxation in the United Kingdom to a different extent depending on the domicile of the resident. Thus, a United Kingdom resident domiciled in the United Kingdom is subject to full United Kingdom taxation on all income, whereas a United Kingdom resident domiciled outside the United Kingdom is generally subject to tax on foreign source income only to the extent that it is remitted to the United Kingdom.

Under United Kingdom law prior to January 1, 1974, the domicile of a woman was the same as the domicile of her husband. This rule has been repealed for future years. However, as a transitional rule, United Kingdom law treats a woman married before 1974 as retaining her husband's domicile unless and until she changes her domicile by acquisition or revival of another domicile after 1973.

As a consequence, under United Kingdom law a United States citizen woman married to a man domiciled in the United Kingdom prior to January 1, 1974 does not have the same opportunity to prove a domicile outside the United Kingdom as does a United States citizen man married to a woman domiciled in the United Kingdom. Paragraph (4) of the Convention puts the United States citizen woman in the same position as the United States citizen man.

Paragraph (5) provides a special rule for cases where income dealt with by this Convention (e.g., under Articles 7 (Business Profits), 8 (Shipping and Air Transport), 10 (Dividends), 11 (Interest), 12 (Royalties), and 22 (Other Income)), is taxable to a resident of a Contracting State only if, and to the extent, it is remitted to or received by that person. In certain cases, individuals who are residents of the United Kingdom are not taxable on foreign source investment income, unless it is remitted to or received by them in the United Kingdom. If such income is received outside of the United Kingdom, or accumulated by the payer, a United Kingdom resident may not be subject to tax on that income. If the reductions in rates or exemptions from tax were to apply to those items of income, the United States would be foregoing tax where double taxation does not in fact occur. Thus, this paragraph provides that if under the law in the other Contracting State income would only be taxed on a remittance basis, then any reduced rates of tax (e.g., as provided by Articles 10 (Dividends)), or relief from taxation (e.g., Articles 7 (Business Profits) and 8 (Shipping and Air Transport), 11 (Interest), or 12 (Royalties)) provided by this Convention shall apply only to the extent such income is remitted to or received by the person in the year in which it accrues to the benefit of that taxpayer. This rule applies to all persons, including individuals, corporations, partnerships and trusts or estates taxable as such.

This provision is similar to paragraph (4) of Article II of the 1945 Convention.

ARTICLE 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment." The existence of a permanent establishment is relevant under Article 7 (Business Profits) where it is provided that the business profits of an enterprise of a Contracting State shall be taxable only in that State unless it carries on business in the other Contracting State through a permanent establishment situated therein.

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which an enterprise of one of the Contracting States wholly or partly carries on business. Illustrations in paragraph (2) of a permanent establishment include a branch; an office; a factory; a workshop; a mine, oil or gas well, quarry or other place of extraction of natural resources; and a building site, or construction or installation project which exists for more than twelve months. Under the construction or installation project rule the twelve month period begins only when work physically commences in the other Contracting State. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the twelve months test. As a general rule, any fixed facility or premises through which a resident carries on business for an indefinite or substantial period of time will be treated as a permanent establishment unless it is used only for one or more of the activities described in paragraph (3) of this Article.

Paragraph (3) specifically provides that a permanent establishment does not include a fixed place of business if it is used solely for one or more of the following activities:

"(*a*) the storage, display, or delivery of goods or merchandise belonging to the enterprise;

"(*b*) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of storage, display or delivery;

"(*c*) the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of processing by another person;

"(*d*) the maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise;

"(*e*) the maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the enterprise; or

"(*f*) a building or construction or installation project which does not exist for more than 12 months."

As noted, these exceptions are cumulative and a fixed place of business used only for one or more of these purposes will not be considered a permanent establishment under the Convention.

Under paragraph (4), a person acting in one Contracting State on behalf of a resident of the other Contracting State, other than an agent of an independent status to whom paragraph (5) applies, will be deemed to constitute a permanent establishment if such person has, and habitually exercises in that first-mentioned Contracting State, an authority to conclude contracts in the name of the resident, unless the contracts are limited to the activities described in paragraph (3) of this Article.

On the other hand, paragraph (5) provides that an enterprise of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such enterprise carries on business in such other Contracting State through a broker, general commission agent, or any other agent of an independent status, where such broker or agent is acting in the ordinary course of his business.

Under paragraph (6), the fact that a corporation which is a resident of a Contracting State controls or is controlled by a corporation of the other Contracting State, or which carries on business in the other Contracting State, through a permanent establishment or otherwise shall not of itself constitute either corporation a permanent establishment of the other.

ARTICLE 6. INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

Paragraph (1) provides that income from immovable property including income from agriculture or forestry, may be taxed in the Contracting State

where the property is situated. This rule does not confer an exclusive right of taxation to the State where the property is located, but only confirms that the situs State has the primary right to ax such income regardless of whether the income is derived through a permanent establishment in that State.

Paragraph (2) provides that the term "immovable property" is to be defined under the laws of the Contracting State where the property is located. Generally, the term "immovable property" refers to real property for purposes of United States and United Kingdom law. Moreover, paragraph (2) also defines the term "immovable property" to include usufruct of immovable property and rights to variable or fixed payments (e.g., royalties) as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources (e.g., oil or gas wells). Ships, boats and aircraft shall not be regarded as immovable property.

This Article shall apply to income derived from the use in any form of immovable property, including income from leases of immovable property, but it does not include interest on indebtedness secured by real property (e.g., mortgages).

Where income is derived from immovable property through a permanent establishment in a Contracting State, such income may be taxed in accordance with Article 7 (Business Profits).

Income from immovable property does not include gains from the sale of immovable property. Where those gains are capital gains within the meaning of Article 13 (Capital Gains), that Article shall apply.

This Article differs from the provisions of Article IX of the 1945 Convention. During the years since that Convention was ratified both the United States and the United Kingdom have enacted statutes permitting the taxpayer to elect to treat income in respect of real property, wells, mines and other natural resources, as income from a trade or business. In these cases, the taxpayer is taxed only on net income rather on the gross income derived from such operations. Thus, it was determined that this Convention need not continue the terms of the 1945 Convention.

ARTICLE 7. BUSINESS PROFITS

Paragraph (1) provides that business profits (as defined in paragraph (7) of this Article) of an enterprise of one Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein, except where the enterprise is a national of that other Contracting State. (See the saving clause in paragraph (3) of Article 1 (Personal Scope)). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). Where business is carried on through a permanent establishment in the other Contracting State, the business profits attributable to the permanent establishment can be taxed by that other Contracting State.

Business profits may be attributable to a permanent establishment which an enterprise of one Contracting State has in the other Contracting State, whether from sources within or without a Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code which are attributable to a permanent establishment situated in the United States will be subject to tax by the United States.

In determining the proper attribution of business profits under the Convention to a permanent establishment, paragraph (2) provides that both Contracting States will attribute to the permanent establishment such profits as it would reasonably be expected to derive if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

Under paragraph (3), expenses, wherever incurred, which are reasonably connected with profits attributable to the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the enterprise as a whole (or in part which includes the permanent establishment), will be allowed as deductions in determining the business profits of the permanent establishment. However, in determining the amount of the deduction under paragraph (3) for expenses incurred by the head office, the deduction

generally will be limited to the expense incurred without including a profit element for the head office.

Under paragraph (4) profits shall not be attributed to a permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment for the account of the enterprise. Paragraph (2) of the Article does not override paragraph (4). Thus, for example, where a permanent establishment purchases goods for its head office, the business profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a notional figure for profits from purchasing.

For purposes of this Article, paragraph (5) provides that the profits attributed to a permanent establishment shall be determined by the same method every year unless there is a good reason to change such method. The purpose of this provision is to give assurance of continuous and consistent tax treatment.

Paragraph (6) provides that, where the profits of a permanent establishment include items of income which are dealt with separately in other Articles of the Convention, the provisions of those Articles will not be affected by the provisions of this Article. Thus, for example, the taxation of interest income will be controlled by Article 11 (Interest) and not by this Article unless, as provided by paragraph (4) of Article 11, the interest is effectively connected with a permanent establishment which the recipient, being a resident of one of the Contracting States, has in the other State. This same exception applies with respect to items of income dealt with in Article 8 (Shipping and Air Transport), dividends under paragraph (4) of Article 10 (Dividends), royalties under paragraph (4) of Article 12 (Royalties) or other income under paragraph (2) of Article 22 (Other Income).

Under paragraph (7), the term "business profits" includes, but is not limited to, income derived from manufacturing, mercantile, banking, insurance (or reinsurance), agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, the rental of tangible personal (movable) property, and the rental or licensing of motion picture films or films or tapes used for radio or television broadcasting or from copyrights thereof. Thus, for example, income derived by a resident of the United States from the rental of tangible personal property to a person in the United Kingdom shall not be subject to tax in the United Kingdom unless that lessor has a permanent establishment in the United Kingdom to which such income is attributable. The term "business profits" also includes any other income which is effectively connected with a permanent establishment which the recipient, being a resident of one of the Contracting States, has in the other Contracting State. The term "business profits" does not include income from the performance of personal services derived by an individual either as an employee or in an independent capacity. Income from such activities is dealt with under Articles 14 (Independent Personal Services), 15 (Dependent Personal Services) and 17 (Artists and Athletes), as the case may be.

This Article is substantially similar to Article III of the 1945 Convention and is also based on Article 7 (Business Profits) of the OECD Model Convention.

ARTICLE 8. SHIPPING AND AIR TRANSPORT

Paragraph (1) provides that profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that Contracting State.

Paragraph (2) confirms that the United Kingdom grants to nationals of the United States and United States corporations the equivalent shipping and aircraft exemption required for application of Code sections 872(b) and 883. It should be noted that the exemption provided under this paragraph is available only with respect to the profits derived from operating ships documented or aircraft registered under the laws of the United States.

Under paragraph (3), this Article applies to profits derived from the rental of ships or aircraft under a bareboat charter if the lessor is engaged in the operation of ships or aircraft in international traffic and the rental income is incidental to operations of the lessor described in paragraph (1). In these cases the lessee of the property need not be a resident of a Contracting State. For example, if an airline which is a resident of one Contracting State has excess

equipment in the winter months and leases several of its aircraft which are not required by it during that period to another airline, the rental profits of the lessor are not subject to tax by that other Contracting State, regardless of the state of residence of the lessee.

Paragraph (4) provides that profits derived by an enterprise of a Contracting State from the use, maintenance, or rental of containers (including trailers and related equipment for the transport of containers), used to transport goods or merchandise shall be taxable only in that State except to the extent that those goods or merchandise are transported solely between places within a Contracting State. The income covered by this provision need not be incidental to the operation of ships or aircraft. Thus, this Article applies to lessors of containers who do not own or operate the ships or aircraft upon which the containers are carried. This paragraph also applies to income derived by an enterprise from the use, maintenance, and lease of containers and other related equipment in connection with the operation of ships or aircraft described in paragraph (1).

Paragraph (5) provides that this Article shall also apply to profits derived by an enterprise of a Contracting State from participation in a pool, a joint business or an international operating agency.

Paragraph (6) provides that gains of an enterprise of a Contracting State from the alienation of ships, aircraft or containers owned and operated by the enterprise shall be taxable only in that State if the income from such ships, aircraft or containers is taxable only in that State.

Except for paragraph (2), this Article is subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Therefore, a Contracting State may tax income from shipping or air transport, or from the use or rental of containers, derived by a resident of the other Contracting State without regard to this Article if such resident is a national of the first-mentioned Contracting State.

ARTICLE 9. ASSOCIATED ENTERPRISES

Article 9 confirms the authority of the United States under section 482 of the Code. Thus, where a enterprise of a Contracting State is related to another enterprise and conditions are made or imposed between them in their commercial or financial relations which are different from those which would be made between independent enterprises, under paragraph (1) an income, deductions, receipts or outgoings which would, but for those conditions, have been attributed to one of the enterprises, but by reason of those conditions have not been so attributed, may be taken into account in computing the profits and losses of that enterprise and taxed accordingly.

Paragraph (2) sets forth an explicit formulation of the consequence of a redetermination made in accordance with paragraph (1) by a Contracting State. In such event, the other Contracting State shall make such corresponding adjustment as may be appropriate to the amount of tax charged to the related enterprise by the other Contracting State. In the case of the United States, assuming application within a reasonable time after notice of such adjustment, any refunds of tax in respect of such an adjustment shall be made notwithstanding the statute of limitations.

Under paragraph (3), if a Contracting State disagrees with a redetermination of tax by the other Contracting State, the two Contracting States will endeavor to resolve the matter in accordance with the mutual agreement procedure in Article 25 (Mutual Agreement Procedure).

Paragraph (4) deals with the methods by which a Contracting State or a political subdivision or local authority thereof may tax an enterprise which is controlled by an enterprise of the other Contracting State. Where an enterprise doing business in one Contracting State is a resident (as defined in Article 4 (Fiscal Residence)) of the other Contracting State, or is controlled, directly or indirectly, by an enterprise which is a resident of the other Contracting State, the first mentioned Contracting State, or political subdivision or local authority thereof, in determining the tax liability of the enterprise doing business therein, may not take into account the income, deductions, receipts, or outgoings of a related enterprise which is a resident of the other Contracting State or of an enterprise of any third State which is related to the enterprise of the other Contracting State. (Because a corporation is considered a single enterprise regardless of how many branches it has, a State may take into account the income and assets of all branches of that corporation, wherever

located.) The taxing jurisdiction may, however, attribute income to the enterprise under the arm's-length principles contained in the other paragraphs of this Article. In addition, where the enterprise which is a resident of the other Contracting State is a corporation, the provisions of paragraph (4) of this Article will apply only if such corporation: (1) is not a controlled foreign corporation within the meaning of Code section 957; (2) is not created or organized under the laws of the first-mentioned Contracting State or any third State; and (3) is not controlled, directly or indirectly, by a corporation which is a resident of any third State.

Finally, the prohibition contained in paragraph (4) will not apply where the enterprise doing business in a Contracting State is a resident of that State to the extent that it owns, directly or indirectly, the capital of a related enterprise. Thus, this provision does not affect the application of the United States "subpart F" rules of Code sections 951–964.

The following is an illustration of the operation of this paragraph: Corporation M, organized under the laws of the United Kingdom, is a resident of the United Kingdom, and all of its stock is owned by individuals residing in the United Kingdom who are not United States nationals. Corporation M controls subsidiaries A, B, and C, which are incorporated in, and do business in, respectively, France, Germany, and Belgium. Corporation M also controls a United States subsidiary, Z, which is incorporated in and conducts its business in X, a state of the United States. In determining the tax liability of Z, to X or to the United States, neither X nor the United States, are permitted to allocate to, apportion to, or otherwise include in Z's tax base income earned by M, A, B, or C, except to the extent the dealings between Z and those persons require the application of the arm's-length principles of the other paragraphs of this Article. Thus, in these circumstances, the United States or the states will be required to determine Z's tax liability solely on the basis of its income. The determination of Z's tax liability under any unitary or combined reporting basis is, therefore, prohibited by this Article.

The broad standard of tax jurisdiction embodied in United States tax treaties provides that one Contracting State will not tax the business profits of an enterprise of the other Contracting State unless that enterprise does business in the first-mentioned Contracting State through a permanent establishment located there. The purpose of this provision is to harmonize the tax jurisdiction under this Convention at the national, state and local levels by equating the tax base of an enterprise doing business in a state or political subdivision of the United States with the enterprise's Federal income tax base.

Paragraph (5) provides that for purposes of the Convention an enterprise is related to another enterprise if either owns or controls directly or indirectly the other, or if a third person or persons (related to each other or acting together) own or control, directly or indirectly, both. The term "control" is not limited to the ownership of the capital of an enterprise, and includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

ARTICLE 10. DIVIDENDS

Article 10 deals with the taxation of dividends derived from a corporation which is a resident of a Contracting State. Under Article VI of the 1945 Convention, the rate of tax on dividends derived by residents of one Contracting State from a corporation of the other Contracting State is limited to 15 percent of the gross amount of the dividends. In 1973 the United Kingdom introduced a system of integrating corporate and shareholder taxation. Under the system adopted by the United Kingdom, a special "Advance Corporation Tax" ("ACT" hereafter), is collected at the corporate level on a distribution of dividends by the corporation. This tax is treated both as an advance payment of a portion of the corporate income tax, and also as a payment by an individual United Kingdom resident shareholder in satisfaction of his personal tax liabilities on the dividend. The introduction of this system rendered inapplicable the current provisions of the Convention relating to United Kingdom dividends. Accordingly, the proposed Article provides a mechanism by which United States shareholders of a United Kingdom corporation will receive the benefits of the shareholder credits which have heretofore not been granted to United States residents.

This Article contains two alternatives for the taxation of dividends, depending on whether the United Kingdom continues to allow a tax credit to indivi-

dual shareholders in respect of dividends derived from a corporation which is a resident of the United Kingdom. Paragraph (1) will apply only if the United Kingdom modifies its current system of shareholder credits. This paragraph limits the tax on dividends paid by a corporation which is a resident of one Contracting State to a resident (who derives and beneficially owns the dividend) of the other Contracting State to 15 percent of the gross amount of the dividends. As noted above, this is the rule contained in the 1945 Convention.

Paragraph (2) applies where, as at the present time, an individual resident in the United Kingdom is entitled to a credit in respect of dividends paid by a corporation which is a resident of the United Kingdom. So long as this system remains in force, only paragraph (2), and not paragraph (1), shall apply. With respect to dividends paid by a corporation resident in the United Kingdom to a United States corporation which either alone or together with one or more associated corporations (defined below) controls, directly or indirectly, at least 10 percent of the voting stock of the United Kingdom resident corporation which is paying the dividend, the shareholder will be entitled to payment from the United Kingdom of a tax credit (hereinafter referred to as a refund) equal to one-half of the tax credit to which an individual resident in the United Kingdom would be entitled, less 5 percent of the aggregate amount of the cash dividend and the United Kingdom refund.

For United States tax purposes, the gross amount of the refund (without reduction for the tax withheld) will be considered as a dividend (see discussion under Article 23 (Elimination of Double Taxation)) and the 5 percent tax withheld will be considered as a tax on the shareholder receiving the dividend (see paragraph (1)(b) of Article 23 (Elimination of Double Taxation)). The unrefunded portion of the ACT paid in respect of the dividend will be regarded as an income tax imposed on the distributing corporation (see paragraph (1)(c) of Article 23).

In the case of United States shareholders other than corporations which control at least 10 percent of the voting stock of the United Kingdom resident corporation, the United Kingdom refund will equal the full credit payable to an individual resident in the United Kingdom, less 15 percent of the aggregate amount of the dividend and the U.K. refund. For United States tax purposes, the U.K. refund shall be treated as additional gross income and the 15 percent withholding shall be considered as a tax on the shareholder. In the case of a $65 dividend, the result is as follows:

Dividend for U.S. Tax Purposes

Dividend—$65; U.K. refund—$35; Gross Dividend $100. United Kingdom withholding tax—$15; foreign tax credit—$15.

With respect to dividends paid by a United States corporation to a corporation which is a resident of the United Kingdom, and which controls, directly or indirectly, at least 10 percent of the voting stock of the United States corporation paying the dividend, the United States tax shall not exceed 5 percent of the gross dividend.

In all other cases of dividends paid by a United States corporation to any other resident of the United Kingdom, the rate of tax imposed by the United States shall not exceed 15 percent.

For purposes of paragraph (2), two corporations are associated if one controls directly or indirectly more than 50 percent of the voting power in the other corporation, or a third corporation controls more than 50 percent of the voting power in both of them.

As noted above, a resident of a Contracting State may benefit from this Article only if he derives and beneficially owns the dividend paid by a corporation of one of the Contracting States. A nominee or agent which is a resident of a Contracting State may not claim the benefits of this Article if the dividend is received on behalf of a person who is not a resident of that Contracting State. Similarly, dividends received by a nominee for the benefit of a resident, as, for example, with respect to a depositary receipt, would qualify for the benefits of this Article. This is generally the case with respect to all income tax conventions of the United States.

Paragraph (3) defines the term "dividends" to include any item which is treated as a distribution under the laws to the United Kingdom for United Kingdom tax purposes or, as a distribution out of earnings and profits for United States tax purposes. Distributions which are not within this definition of "dividends", or covered by any other provision of this Convention, shall be

treated as "other income" under Article 22 (Other Income) of this Convention.

Paragraph (4) provides that paragraph (1) and (2) of this Article shall not apply if the person deriving the dividends, being a resident of a Contracting State, has a permanent establishment in the other Contracting State or performs personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with the permanent establishment or fixed base. In such a case, the dividends will be treated as business profits subject to the provision of Article 7 (Business Profits) or taxable in accordance with Articles 14 (Independent Personal Services) or 17 (Artistes and Athletes), as the case may be.

Paragraph (5) provides that dividends paid by a corporation which is a resident of a Contracting State, regardless of where it derives its income, to a person other than a resident of the other Contracting State (and in case of dividends paid by a corporation which is a resident of the United Kingdom, to a person other than a United States citizen), shall be exempt from tax by the other Contracting State unless the holding with respect to which such dividends are paid is effectively connected with a permanent establishment or a fixed base which the person deriving the dividends has in that other State. For example, if a corporation which is a resident of the United Kingdom and is doing business in the United States pays dividends to a resident of the United Kingdom, or to a resident of a third State, those dividends shall be exempt from United States tax unless they are paid to a citizen or resident of the United States, or unless the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base which the United Kingdom resident or resident of a third State maintains in the United States. This rule is contained in Article XV of the 1945 Convention. A dual-resident corporation which derives dividends from a resident of a Contracting State may not claim the benefits of this provision, although dividends received from a dual-resident corporation will qualify for the benefits of this Article.

Paragraph (6) continues the provisions of Article XVI of the 1945 Convention, and provides that a corporation which is a resident of the United Kingdom shall be exempt from the United States tax on accumulated or undistributed earnings (as provided by Code sections 531 (the accumulated earnings tax) and 541 (the personal holding company tax)), if individuals, other than citizens of the United States, who are residents of the United Kingdom control, directly or indirectly, more than 50 percent of the entire voting power in such corporation.

Paragraph (7) prevents the application of paragraphs (1) and (2) of this Article in two circumstances where tax avoidance may occur. First, under subparagraph (a), where a resident of a Contracting State owns 10 percent or more of the shares of a corporation with respect to which dividends are paid, paragraphs (1) or (2) of this Article shall not apply to the extent that the dividends are paid out of profits whcih the corporation earned or other income which it received in a period ending 12 months or more before the date on which the shareholder became the owner of 10 percent or more of the corporation's stock. This rule is designed to prevent transactions where a 10 percent stock interest is acquired in order to obtain a distribution of the past earnings of a corporation at reduced rates of tax.

A second rule contained in subparagraph (b) is designed to deny the benefits of the Convention to tax exempt organizations if the recipient of a dividend is exempt from tax in the United States and the dividends are received in circumstances where if received by an exempt organization of United Kingdom such interest or dividend would not be so exempt. Under United Kingdom law, if a resident of the United Kingdom sells securities to an exempt organization immediately before the payment of dividends, the organization will be taxable on the dividends paid in respect of the securities if the transaction was designed to accord the initial seller a preferential rate of tax on his sale. This rule is contained in Article VII A of the 1945 Convention.

The rules of paragraph (7), stated above shall not apply if the beneficial owner of the shares satisfies the competent authorities of the respective States that the shares were acquired for bona fide commercial purposes and not to secure the benefits of the Convention.

This Article is subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Thus, dividends derived by a citizen of a Contracting State may be taxed by that Contracting State without regard to this Article.

Paragraphs (1) and (2) provide that interest derived and beneficially owned by a resident of one Contracting State shall be exempt from tax by the other Contracting State. In these cases, interest is taxable only in the taxpayer's State of residence. The exemption only applies where the person deriving the interest is a resident of a Contracting State (as defined in Article 4 (Fiscal Residence)) and is the beneficial owner of the interest. Thus, the exemption does not apply where an intermediary, which is a resident of a Contracting State, such as an agent or nominee, collects or receives the interest on behalf of a person who is not a resident of that Contracting State.

Paragraph (3) defines the term interest for purposes of this Article as income from Government securities, bonds or debentures, whether or not secured by mortgage or whether or not carrying a right to participate in profits, and debt claims of every kind, as well as all other income (such as original issue discount) which, under the taxation law of the Contracting State in which the income has its source, is assimilated to income from money lent. Paragraphs (1) and (2) apply to all "interest," from whatever source derived. Penalty charges and late payment penalties shall not be regarded as interest. Such payments shall be regarded as "other income" dealt with by Article 22 (Other Income).

Paragraph (4) provides that the exemption from tax provided by paragraphs (1) and (2) shall not apply if the person deriving the interest, being a resident of a Contracting State, has a permanent establishment in the other Contracting State or performs personal services from a fixed base situated therein, and the indebtedness giving rise to the interest is effectively connected with the permanent establishment or fixed base. In such a case, the interest will be treated as business profits subject to the provisions of Article 7 (Business Profits) or will be taxable in accordance with Articles 14 (Independent Personal Services) or 17 (Artistes and Athletes), as the case may be.

If excessive interest is paid pursuant to a special relationship between the payer and the person deriving the interest or between both of them and a third person, under paragraph (5) the provisions of Article 11 shall not apply to the excess portion of the payment. For this purpose, those persons need not be "related" within the meaning of paragraph (5) of Article 9 (Related Enterprises). The excessive portion may be taxed by each Contracting State, in accordance with its own law, including the Convention where applicable. In the case of the United States, the excessive portion may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) will apply.

Paragraph (6) provides that interest paid by a resident of a Contracting State, regardless of where it derives its income, to a person other than a resident of the other Contracting State (and in the case of interest paid by a resident of the United Kingdom, to a person other than a United States citizen), shall be exempt from tax by the other Contracting State unless the debt claim in respect of which such interest is paid is effectively connected with a permanent establishment or a fixed base which the person deriving the interest has in that other State. For example, if a corporation which is a resident of the United Kingdom and is doing business in the United States pays interest to a resident of the United Kingdom, or to a resident of a third State, that interest shall be exempt from United States tax unless it is paid to a citizen or resident of the United States, or unless the debt obligation is effectively connected with a permanent establishment or a fixed base which the United Kingdom resident or resident of a third State maintains in the United States. A dual-resident corporation may not claim the benefits of this provision. A debt obligation is effectively connected with a permanent establishment in the United States when interest on that obligation is effectively connected with a trade or business in the United States within the meaning of Code section 864(c)(2) or 864(c)(4)(B)(ii), depending on the source of the interest under United States law.

Paragraph (7) is carried over from paragraph (5) of Article VII of the 1945 Convention. Under United Kingdom domestic law, interest payments by United Kingdom corporations to non-United Kingdom corporations which have 75 percent or more control, directly or indirectly, of the United Kingdom corporation are treated as distributions (dividends) rather than as deductible interest. This paragraph provides, in reciprocal terms, that this rule shall not apply where the payment is to a resident of the other Contracting State. By

virtue of paragraph (2) of Article 1 (Personal Scope), a dual-resident corporation may claim the benefits of this provision with respect to interest payments it makes. However, this paragraph also provides that where the interest is paid to a corporation which is a resident of a Contracting State of which more than 50 percent of the voting power is directly or indirectly controlled by persons who are residents of the other Contracting State, the exemption shall not apply.

Paragraph (8) provides that the exemption from United Kingdom tax under paragraph (2) of this Article will not apply if the recipient of the interest is exempt from tax on such income in the United States and the recipient sells or makes a contract to sell the holding from which such interest is derived within three months after the date the recipient acquired such holding.

The provisions of this Article are subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Thus, interest derived by a citizen of a Contracting State may be taxed by that Contracting State without regard to this Article.

ARTICLE 12. ROYALTIES

Paragraphs (1) and (2) provide that royalties derived and beneficially owned by a resident of a Contracting State shall be exempt from tax by the other Contracting State. Such income, therefore, is taxable only in the State of residence. As in Article 10 (Dividends) and 11 (Interest), this exemption applies only where the person deriving the royalties is a resident of a Contracting State and is the beneficial owner of the royalty. Thus, the exemption does not apply where an intermediary, such as an agent or nominee, who is a resident of a Contracting State collects or receives the royalties on behalf of a nonresident of that Contracting State. This Article deals with royalties from sources within a Contracting State or from sources within any third State, except as described below.

Paragraph (3) defines the term "royalties" as payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works (but not including copyrights of motion picture films or films or tapes used for radio or television broadcasting (which are treated as business profits under paragraph (7) of Article 7 (Business Profits)), patents, trade mark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience. This term includes know-how and similar experience or skill, including the supply of assistance of an ancillary and subsidiary nature furnished as a means of enabling the application or enjoyment of any such right or property. The term also includes gains derived from the alienation (e.g.; the sale, exchange, or other disposition) of any such right or property to the extent the amounts realized on such alienation are contingent on the productivity, use, or disposition of the right or property. If the amounts realized are not so contingent, the provisions of Article 13 (Capital Gains) may apply. The article does not apply to amounts which are characterized as interest pursuant to section 483 of the Code.

Paragraph (4) provides that paragraphs (1) and (2) will not apply if the royalty recipient, being a resident of one Contracting State, carries on business in the other Contracting State through a permanent establishment situated herein or performs in that other Contracting State personal services from a fixed base situated therein, and the right or property giving rise to the royalty is effectively connected with such permanent establishment or fixed base. In such a case, the royalty will be treated as business profits subject to Article 7 (Business Profits) or will be taxable in accordance with Articles 14 (Independent Personal Services) or 17 (Artistes and Athletes) as the case may be.

If excessive royalties are paid pursuant to a special relationship between the payer and the person deriving the royalty or between both of them and a third person, paragraph (5) provides that the provisions of this Article shall not apply to the excessive portion of the payment. For this purpose, the persons covered by this paragraph need not be "related" within the meaning of paragraph (5) of Article 9 (Related Enterprises). The excessive portion may be taxed in each Contracting State, in accordance with its own law, including the Convention where applicable. In the case of the United States, the excessive portion may, for example, be taxed as a dividend, in which case the provisions of Article 10 (Dividends) will apply.

This Article is subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Therefore, royalties derived by a citizen of a Contracting State may be taxed by the Contracting State without regard to this Article.

ARTICLE 13. CAPITAL GAINS

This Article provides that, except as provided in Article 8 (Shipping and Air Transport) capital gains are taxable in accordance with the domestic laws of the Contracting States. This rule applies to the existing laws of a Contracting State respecting the taxation of capital gains and revisions of those laws subsequent to the effective date of this Convention. Thus, for example, capital gains in respect of the sale of immovable property described by Article 6 (Immovable Property) or the sale of a right or property giving rise to royalties described by Article 12 (Royalties) (which are not contingent on productivity, etc.,) may be taxed in accordance with the respective domestic laws of the Contracting States. The provisions of Article 7 (Business Profits) shall apply to gains attributable to a permanent establishment. Article 22 (Other Income) does not apply to capital gains.

Under current United States law, contained in Code sections 871 and 872, nonresident alien individuals are generally not taxable in the U.S. on their United States source capital gains unless they are present in the United States for 183 days or more during a taxable year, or if the gains are effectively connected with the conduct of a U.S. trade or business. Under Code sections 881 and 882 foreign corporations generally are taxable in the U.S. only on capital gains which are effectively connected with the conduct of a U.S. trade or business.

Notwithstanding the foregoing rules, under paragraph (6) of Article 8 (Shipping and Air Transport) gains which an enterprise of a Contracting State derives from the sale, exchange or other disposition of ships, aircraft or containers which the enterprise owns or operates (dealt with by Article 8 (Shipping and Air Transport)), shall be taxable only in the State in which the income from the ships, aircraft or containers was taxable.

Under paragraph (2) of Article 3 (General Definitions), whether an item of income constitutes a capital gains shall be determined under the laws of the Contracting State seeking to tax those gains.

The representatives of the Contracting States will consult with each other upon the enactment or proposed enactment by either State of any laws which substantially change the manner in which capital gains derived by nonresidents are taxed by the respective States.

ARTICLE 14. INDEPENDENT PERSONAL SERVICES

In dealing with the taxation of income from personal services, the Convention distinguishes between "independent" and "dependent" personal services. The Convention also provides special treatment for individuals who are "artistes or athletes" and for amounts received in certain circumstances in respect of the services of an artiste or athlete.

Personal services performed in an independent capacity, that is, independent personal services, are services performed by an individual for his own account where he receives the income and bears the losses arising from such services. If an individual is an independent contractor he is considered as rendering independent personal services. Income from services in which capital is a material income-producing factor, however, will generally be governed by the provisions of Article 7 (Business Profits). Generally, services rendered as a director of a corporation, or rendered by physicians, lawyers, engineers, architects, dentists, consultants, and accountants, performing personal services as sole proprietors or partners, are independent personal services, whereas the income earned by the employees of such persons, or as an officer of a corporation, is considered to be income from dependent personal services.

Under this Article income derived by an individual who is a resident of one Contracting State from the performance of personal services in an independent capacity may be taxed by that Contracting State. Except as permitted by subparagraphs (a) and (b) of this Article, such income will be exempt from tax by the other Contracting State.

Subparagraph (a) provides that income derived from services performed in the other Contracting State may also be subject to tax in that other Contracting State if the individual is present therein for a period or periods exceeding 183 days in the tax year, but only to the extent such income is attributable to services performed in that State. In addition, subparagraph (b) provides that income from personal services may be taxed in the other Contracting State if the individual has a fixed base regularly available to him for the purpose

of performing his activities, but only to the extent such income is attributable to services performed in that State. The term fixed base is synonymous with the term "permanent establishment" as described in Article 5 (Permanent Establishment).

ARTICLE 15. DEPENDENT PERSONAL SERVICES

This Article deals with the taxation of income in respect of dependent personal services. The Article is based on Article 15 (Dependent Personal Services) of the OECD Model Convention. Under paragraph (1), subject to Articles 18 (Pensions) and 19 (Government Service), salaries, wages and other similar remuneration derived by an individual who is a resident of one Contracting State from labor or personal services performed as an employee (of any person) shall be taxed only by that Contracting State unless that employment is exercised in the other Contracting State. Except as provided by paragraph (2), remuneration derived with respect to services performed within the other Contracting State may also be taxed by that other Contracting State. It is intended that for purposes of the Convention the term "salaries, wages and other similar remuneration" includes income from services performed as an officer of a corporation.

Under paragraph (2), remuneration derived by an individual who is a resident of one Contracting State in respect of an employment exercised in the other Contracting State will be exempt from tax by the other Contracting State if: (a) the individual is present in that other Contracting State for a period or periods aggregating less than 183 days in the taxable year; (b) the employee's remuneration is paid by or on behalf of an employer who is not a resident of that other Contracting State; and (c) the remuneration is not borne as such by a permanent establishment or fixed base which the employer has in that other Contracting State. Such income may nevertheless be taxed by that other Contracting State if the individual is a citizen or resident of that Contracting State, pursuant to the saving clause of paragraph (3) of Article 1 (Personal Scope).

In the United States, remuneration from the performance of dependent services will be viewed as not having been borne by the permanent establishment or fixed base maintained in the United States if the employee is performing stewardship or overseeing functions for the benefit of a resident of or a permanent establishment maintained in the United Kingdom. However, the remuneration will be considered to be borne by the permanent establishment or fixed base maintained in the United States if the remuneration is paid for activities other than stewardship or overseeing functions and the permanent establishment or fixed base is entitled to claim the employee's remuneration as a deduction in computing taxable income for United States purposes because the remuneration is definitely related and allocable to its gross income or a class of its gross income pursuant to Code section 861 and the regulations thereunder.

Paragraph (3) provides that, notwithstanding paragraphs (1) and (2) of this Article, remuneration derived by an individual employee in respect of an employment as a member of the regular complement of a ship or aircraft in international traffic may be taxed by the Contracting State of which the employer operating the ship or aircraft is a resident.

ARTICLE 16. INVESTMENT OR HOLDING COMPANIES

This Article provides that a corporation which is a resident of one Contracting State and which derives dividends, interest or royalties arising within the other Contracting State shall not be entitled to claim the benefits of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties), if the tax imposed by the first-mentioned Contracting State with respect to such dividends, interest or royalties is substantially less than the tax generally imposed by that State on corporate profits; and 25 percent or more of the capital of such corporation is owned directly or indirectly by persons who are not individual residents of the first-mentioned Contracting State and are not nationals of the United States.

This Article also provides that a corporation which is a resident of the United States and which derives dividends, interest or royalties arising in the United Kingdom shall not be entitled to the benefits of Articles 10 (Dividends), 11 (Interest), or 12 (Royalties) where more than 80 percent of its gross income (including such dividends, interest, or royalties) is derived from sources outside of the United States as determined by and for the purposes of Code Sections

861(a)(1)(B) and 861(a)(2)(A), and as they may be amended from time to time without changing their general principles. This limitation applies only if 25 percent or more of the capital of the corporation is owned directly or indirectly by persons who are not individual residents of the United States or nationals of the United States.

Paragraph (2) provides that nothing in this Article will prevent a claim under the provisions of Articles 10 (Dividends), 11 (Interest) or 12 (Royalties) by a United States corporation, if 75 percent or more of the capital of that corporation is directly or indirectly owned: (a) by another United States corporation which receives 20 percent or more of its gross income from sources within the United States as determined by and for the period described in sections 861(a)(1)(B) and (a)(2)(A) of the Code, as they may be amended from time to time so as not to affect their general principle; or (b) by a corporation other than a United States corporation which would not be treated as a close company under section 283 of the United Kingdom Income and Corporation Taxes Act of 1970 (as may be amended without changing the general principle thereof); or (c) by a corporation, resident in the United Kingdom, more than 50 percent of the voting power of which is controlled directly or indirectly by individuals who are residents of the United Kingdom.

The purposes of this Article are, first, to prevent the potential abuse of the Convention which would occur if residents of a third country could take advantage of the reduced rates of withholding provided by this treaty in situations where one of the Contracting States provided preferential rates of tax for investment or holding companies deriving foreign source income. In the absence of this Article, residents of a third country could organize a corporation in the Contracting State extending the preferential rates for the purpose of making investments in the other Contracting State. The combination of low tax rates in the first Contracting State and the reduced rates or exemptions in the other Contracting State would enable the third country residents to realize unintended benefits.

The Article is also intended to prevent the use of United States corporations by residents of third countries to take advantage of the reduced rates of tax or exemptions from tax granted by the United Kingdom on dividends, interest and royalties paid to residents (including corporations) of the United States. Generally, under sections 861(a)(1)(B) and 861(a)(2)(A) of the Code, interest and dividends paid by U.S. corporations to nonresidents of the United States are not subject to tax by the United States if more than 80 percent of the corporation's gross income is from sources outside the United States. Accordingly, were it not for this provision, a resident of a third country could establish a United States corporation solely to derive interest or dividends from the United Kingdom subject to the reduced rates and refunds allowed by the Convention. While such income would be subject to normal corporate taxes in the United States, the corporation's dividends or interest to the third country residents would be exempt from U.S. withholding taxes if the conditions of Code sections 861(a)(1)(B) and (a)(2)(A) are met. The Article prevents this abuse where the above mentioned share-ownership requirements apply. Since the purpose of this provision is only to prevent the use of United States corporations in cases where their income would otherwise qualify for reduced withholding rates in the United Kingdom and their distributions to third country residents would not attract United States withholding taxes, exceptions to the rule are given where that corporation is owned by another United States corporation whose distributions would attract United States withholding taxes; where that corporation is owned by a corporation which is not a close company under United Kingdom law; and where that corporation is owned by a corporation resident in the United Kingdom 50 percent or more of the voting power of which is controlled by United Kingdom resident individuals.

ARTICLE 17. ARTISTES AND ATHLETES

This Article deals with the taxation of income derived by entertainers, musicians, and athletes (sometimes referred to hereinafter as "artistes and athletes") in respect of the performance of services in a Contracting State. The Article applies in cases where an artiste or athlete performs services on his own behalf and in cases where services are performed on behalf of another person, as an employee or pursuant to any other arrangement.

Paragraph (1) states the general rule that notwithstanding the provisions of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services), income derived by entertainers such as theatre, motion picture, radio, or television artistes, and musicians or athletes, for their personal activities as such, may be taxed in the Contracting State where those services are exercised. Such income, however, is taxable under this Article only where the gross receipts derived by the artiste or athlete, including expenses reimbursed to him or borne on his behalf, in respect of such activities, exceed $15,000 or its equivalent in pounds sterling for the tax year concerned. In computing the $15,000 limitation, expenses borne on behalf of the entertainer include any expenditures for travel, meals and lodging, payments to persons such as band members or agents, and other amounts which are generally related to the activities of the artiste or athlete. This rule includes expenses borne by persons in the Contracting State where services are performed or borne by persons in the other or any third State if borne on behalf of the artiste or athlete. If the total of these expenses, including the amounts paid to the artiste or athlete, exceed $15,000, the entire amount is taxable in the State where the activities are performed. For example, where an entertainer's gross income, including reimbursed expenses and expenses borne on his behalf, totals $20,000, the full $20,000 is subject to tax in the State where the services are performed.

Also, in computing the $15,000 limitation, amounts paid in taxable years prior or subsequent to the year in which the services were performed shall be included in the determination of the amount of income attributable to the year in which the services were performed.

As noted above, this paragraph overrides the provisions of Articles 14 and 15, so that an artiste or athlete may be taxed in the State where his activities take place regardless of the period of time he is present in that State. Generally, however, income derived from services rendered by producers, directors, technicians and others who are not artistes and athletes is taxable in accordance with the proviisons of Article 14 (Independent Personal Services), or Article 15 (Dependent Personal Services), as the case may be.

Paragraph (2) deals with cases where income in respect of the activities of an entertainer or athlete accrues to a person other than, or in addition to, the entertainer or athlete. A common method employed by foreign entertainers is to perform services in the United States as an employee of, or a contractor for, a corporation or other person. That person may act as the nominal recipient of the income in respect of the entertainer's services and the entertainer may act as its "employee" or "contractor." In such cases, the corporation may escape taxation in respect of those services under the provisions of Article 7 (Business Profits) because it does not have a permanent establishment in the United States described in Article 5 (Permanent Establishment). The entertainer may also escape taxation by being paid a small salary while in the United States and by receiving payment in a later year when the income is subject to reduced rates of tax or no tax at all, or by liquidating the corporation after the services are performed.

Paragraph (2) is designed to deal with these situations by providing that where income in respect of the personal activities of an artiste or athlete accrues to the benefit of another person (including a corporation, trust, or partnership of either Contracting State or any third State), that income may, notwithstanding the provisions of Article 7 (Business Profits), 14 (Independent Personal Services), and 15 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete takes place. Thus, for example, such other person could not claim the permanent establishment protection provided by Articles 5 (Permanent Establishment) and 7 (Business Profits).

For purposes of paragraph (2), income is considered to accrue to the benefit of another person where that other person has control over or the right to gross income derived in respect of an entertainer or athlete's services as such. This rule applies regardless of whether the other person is a "sham" corporation or conduit. Income will not, however, be deemed to accrue to the benefit of another person where it is established to the satisfaction of the competent authority of the Contracting State in which the services are performed that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person, in any manner, including the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions or other distributions. Persons may be considered to be

related to the artiste or athlete regardless of whether the persons are considered to be related under the provisions of paragraph (5) of Article 9 (Related Enterprises). For this purpose, a person may be considered to be related to the artiste or athlete if he is an employee or agent of the artiste or athlete, or if he is regularly employed by the artiste orathlete in an advisory capacity, such as his attorney, accountant, or investment advisor.

This section is similar to provisions in other recent Conventions of the United States with Japan, Trinidad and Tobago, and Iceland, and follows Article 17 (Artistes and Athletes) of the OECD Model Convention. It differs from the 1945 Convention, which under Article XI exempts an entertainer or athlete from United States tax where he: (a) is present in the United States for a period or periods not exceeding 183 days of a taxable year and (b) services are performed for or on behalf of a person who is a resident of the United Kingdom. The application of this section and Article III, regarding the industrial or commercial profits of an enterprise furnishing the services of an entertainer, was discussed in detail in Revenue Rulings 74–330 and 74–331. Both rulings considered cases where the services of foreign entertainers were "loaned" to United Kingdom corporations in order to benefit from the provisions of the 1945 Convention and to thereby avoid any taxation of the income derived in respect of their activities in the United States.

ARTICLE 18. PENSIONS

Paragraph (1) provides that, subject to the provisions of paragraph (2) of Article 19, (Government Service), pension payments received in consideration of past employment and annuity payments paid to an individual who is a resident of a Contracting State shall be taxable only in that State. The term "pension" includes payments from qualified retirement plans as well as other forms of retirement benefits paid for services rendered, or by way of compensation for injuries or sickness incurred in connection with past employment. A pension does not include payments in respect of the cancellation or premature termination of employment contracts (e.g., "golden handshakes" or severance pay). Such payments are taxable under the provisions of Articles 14 (Independen Personal Services), 15 (Dependent Personal Services), or 17 (Artistes and Athletes), as the case may be.

Payments which are not covered by any other Article of this Convention (e.g., Article 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes), or 19 (Government Service), are taxable in accordance with Article 22 (Other Income) in the recipient's State of residence.

For purposes of this Article, the term "pension" does not include social security payments and other public pensions, e.g., railroad retirement benefits. Such items are taxable pursuant to Article 22 (Other Income).

Paragraph (2) provides that alimony paid to an individual who is a resident of a Contracting State is taxable only in the State. The term "alimony" is not defined, but with respect to the United States, means periodic payments made pursuant to a decree of divorce, separate maintenance agreement, or support or separation agreement which is taxable to the recipient under the internal laws of the United States. Thus, for the United States, the term "alimony" would not include a payment which would not be taxable to the recipient even though such payment is made pursuant to a decree of divorce or of separate maintenance agreement. Payments for child support within the meaning of the Code are not covered by this Article and are, accordingly, taxable in the State where the recipient resides under Article 22 (Other Income). In the case of the United States, under present law, a recipient of child support is not taxable on such payments.

Paragraph (3) defines the term "annuity" to mean a stated sum payable periodically at stated times, during life or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration in money or money's worth.

This Article is subject to the saving clause of paragraph (3) of Article 1 (Personal Scope). Thus, individuals who are nationals of a Contracting State may be taxed by that Contracting State without regard to this Article.

ARTICLE 19. GOVERNMENT SERVICE

This Article generally follows Article 19 (Government Service) of the OECD Model Convention and is similar to Article X of the 1945 Convention.

Paragraph (1)(a) provides that remuneration, other than a pension, paid by a Contracting State to an individual for services rendered to that State will be taxable only in that State. This paragraph only applies to individuals who are employees of a Contracting State, and not to employees of a political subdivision or local authority of a Contracting State. Under paragraph (1)(b), such remuneration will be taxable only in the State in which the services are being performed if the recipient is a resident of that State and either is a national of that State or did not become a resident of that State solely for the purpose of performing the services.

Under paragraph (2)(a), any pension paid by a Contracting State or a political subdivision or a local authority thereof to any individual in respect of services rendered to that State or subdivision or local authority thereof will be taxable only in that State. An exception similar to the one contained in paragraph (1)(b) is incorporated in paragraph (2)(b) with respect to pensions. That paragraph provides that a pension described in paragraph (2)(a) will be taxable only in the other Contracting State if the recipient is both a national of and a resident of that State.

Paragraphs (1) and (2) do not apply if the services are rendered in connection with any business carried on by or on behalf of one of the Contracting States or one of its political subdivisions, or local authorities paying the remuneration. In such cases, the provisions of Article 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes), and 18 (Pensions), as the case may be, shall apply.

If an individual acquires immigrant status in the State in which he performs the services or receives the pension, that Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 1 (Personal Scope).

ARTICLE 20. TEACHERS

Paragraph (1) provides that a professor or teacher who visits one of the Contracting States for a period not exceeding two years, for the purpose of teaching or engaging in research at a university, college, or other recognized educational institution in that Contracting State, and who was immediately before that visit a resident of that other Contracting State, will be exemptel from tax by the first-mentioned Contracting State on any remuneraion for such teaching or research for a period not exceeding two years from the date he first visits that State for the purpose of teaching or engaging in research. Since this two year period is determined from the date he first visits the Contracting State, periodic vacations outside the first-mentioned Contracting State, or a brief return to the other Contratcing State will not toll the running of the two year period. Unlike the existing Convention, if the two-year period beginning from the date of his arrival is exceeded, the exemption will be lost retroactively. Thus, if a person comes to a Contracting State for the purpose of teaching and stays for a period in excess of two years, the exemption will not apply for the first two years. A person who meets the qualifications of this provision may again claim its benefits if he first reestablishes his residence in the other Contracting State. In such case, the person claiming these benefits on a subsequent occasion must first satisfy the competent authority of the first-mentioned Contracting State that he had become a bona fide resident of the other State for a substantial period of time (normally at least one year).

Under paragraph (2), the Contracting State in which the teaching or research is performed may apply this exemption either to current payments to a professor or teacher in anticipation of fulfillment of the requirements of paragraph (1) or by way of withholding and refund. Thus, the recipient may be required to report and pay taxes on such income on a current basis and seek a refund of taxes paid upon fulfillment of the requirements of paragraph (1).

If an individual becomes a national of, or acquires immigrant status in, the State where he is visiting, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 1 (Personal Scope).

Pursuant to paragraph (3), this Article only applies to income from research undertaken in the public interest which is not primarily for the benefit of a private person or persons. For example, research projects which are undertaken to discover or perfect product processes, designs, etc., which are expected to be commercially exploited by the researcher of his present (or former) employer do not qualify under this Article.

ARTICLE 21. STUDENTS AND TRAINEES

This Article corresponds generally to Article XIX of the 1945 Convention and Article 20 (Students) of the OECD Model Convention. Under this Article, payments which a student or business apprentice, who immediately before visiting a Contracting State was a resident of the other Contracting State receives for his maintenance, education or training, will not be taxed in the first-mentioned State if the recipient of the payments is engaged in a full-time education or training program and the payments are made from sources outside the State in which the education or training takes place. Payments will be considered to have been made from sources outside a State when they are borne by a person who is not a resident (as defined in Article 4 (Fiscal Residence)) of the Contracting State in which the education or training takes place. Like other articles referred to in paragraph 4(b) of Article 1, this Article will not apply to payments to students or business apprentices who are nationals of or residents with immigrant status in the first-mentioned Contracting State.

ARTICLE 22. OTHER INCOME

This Article follows Article 21 (Other Income) of the OECD Model Convention. It contains the general rule that income of a resident of a Contracting State, from any source, which is not dealt with by any specific Article in the Convention, shall be taxable only in that person's State of residence. This is the first United States tax convention to follow this rule. The scope of this Article is not confined to income having a source in the other Contracting State, but applies to a resident's income from sources in third countries. Moreover, this rule applies irrespective of whether the State of residence exercises its right to tax the income covered by this Article. Specific items of income not dealt with by other Articles of this Convention include child support payments, prizes or awards, and social security payments. These items are subject to the provisions of this Article and are taxable only in the State of residence.

This Article also makes it clear that the United Kingdom may continue to impose its tax on discretionry and accumulation trusts. United Kingdom law currently provides that discretionary and accumulation trusts are subject to the basic rate of income tax (35 percent) and to an additional tax of 15 percent. Trustees are eligible to claim double taxation relief in the respect of foreign tax paid on the income. Under United Kingdom law a distribution of income from a discretionary or accumulation trust is treated in the hands of the beneficiary as a payment from which tax has been deducted at the aggregate of the two rates (35 and 15) in force for the year of payment. That is, the distribution is grossed-up by 100 percent and the amount of the gross-up is treated as tax paid by, and creditable to, the distrbutee in the year of distribution.

Under paragraph (1) of Article 22 (Other Income) and paragraph (3) of Article 25 (Mutual Agreement Procedure), the United Kingdom will continue to impose its taxes on discretionary and accumulation trusts and will not be obligated to refund these taxes at the time of distributions to United States residents. However, to give double taxation relief, the United Kingdom will treat a United States person taxable on the income as if he were entitled to receive the income of the trust directly. Thus, the beneficiary will be given the benefit of relief provisions in United Kingdom domestic law (e.g., government securities held by non-residents). Additionally, any income covered by the Convention, such as dividends and interest, will receive the benefits of the Convention to the extent that the payments from the trust are made out of this income.

This Article is subject to the saving clause provisions of paragraph (3) of Article 1 (Personal Scope).

This Article does not apply if the resident deriving the income carries on business in the other Contracting State through a permanent establishment situated therein or performs independent personal services from a fixed base therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such cases, the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), or 17 (Artistes and Athletes) as the case may be, apply. As in the case of paragraph (1), this paragraph applies to income from all sources.

It should be noted that the proposed Convention specifically covers most types of income.

ARTICLE 23. ELIMINATION OF DOUBLE TAXATION

In order to prevent the double taxation of income covered by this Convention, each Contracting State agrees in this Article to provide a credit against its taxes for taxes paid to the other Contracting State.

Under paragraph (1), the United States agrees to allow a United States citizen or resident as a credit against United States tax the appropriate amount of taxes paid or accrued to the United Kingdom in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle of paragraph (1)). In addition, in the case of a United States corporation owning at least ten percent of the voting stock of a United Kingdom corporation from which it receives dividends in any taxable year, the United States will allow credit for the appropriate amount of taxes paid or accrued to the United Kingdom by the United Kingdom corporation paying such dividends with respect to the profits out of which such dividends are paid. The rules for calculating the appropriate amount of taxes creditable in such a case are set forth below. However, the amount of tax credit is not to exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within the United Kingdom or on income from sources outside of the United States) provided by United States law for the taxable year. This provision does not require the United States to maintain a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect.

For the purpose of applying the United States credit in relation to taxes paid to the United Kingdom, the taxes referred to in paragraphs (2)(b) and (3) of Article 2 (Taxes Covered) shall be considered to be income taxes. In the case of dual-resident corporations described by paragraph (2) of Article 1 (Personal Scope), the United Kingdom petroleum revenue tax and the unrefunded portion of the ACT referred to in paragraph (1)(c) of this Article shall be regarded as an income tax for purposes of this Article. (See paragraph (2) of Article 1 (Personal Scope)). Any other taxes imposed by the United Kingdom on such corporation shall be treated as income taxes for purposes of the United States tax credit only in accordance with the laws of the United States.

Under paragraphs (2)(a)(i) and (2)(a)(ii) of Article 10 (Dividends), the United Kingdom allows residents of the United States certain tax credits or refunds in respect of dividends paid by a corporation which is a resident of the United Kingdom, subject to taxes withheld of 5 or 15 percent on the aggregate amounts received as dividends and tax credits. Subparagraph (1)(b) of this Article provides that the amounts withheld (5 or 15 percent) by the United Kingdom pursuant to paragraph 2(a)(i) or (ii) of Article 10 (Dividends) from the refund paid to residents of the United States shall be regarded as an income tax imposed on the recipient of the dividend. Thus, the United States foreign tax credit with respect to those amounts shall be computed in accordance with Code section 901.

In the case of tax credits allowed to corporate shareholders of a corporation which is a resident of the United Kingdom pursuant to subparagraph (2)(a)(i) of Article 10, only one-half of the credit otherwise paid to individual shareholders is paid to those corporate shareholders. Subparagraph (1)(c) of this Article provides that the portion of the credit not paid to these corporate shareholders, i.e., one-half of the ACT paid in respect of the distribution, shall be treated as an income tax imposed on the corporation paying the dividend.

In the United Kingdom tax system, ACT serves a dual function. To the extent that it offsets the United Kingdom corporate income tax imposed without regard to distributions (hereinafter referred to as "mainstream tax"), it is analogous to a payment of regular corporate income tax. To the extent that it does not offset mainstream tax, it is more analogous to a tax imposed on distributions which are income to the shareholders.

To reflect this hybrid nature of ACT, ACT which offsets mainstream tax will be attributed to the earnings of the year in which it offsets such tax and treated as if it were regular corporate tax. ACT which does not offset mainstream tax will generally be attributed to the accumulated profits of the year of distribution.

In order that the derivative foreign tax credit be computed as intended under the Convention, corporate shareholders receiving the benefits of subparagraph 2(a)(i) of Article 10 (Dividends) must apply the following rules:

1. ACT paid with respect to a distribution shall be treated as attributable to the accumulated profits (determined under U.S. principles) of the year of distribution, except in two circumstances:

(a) to the extent the ACT reduces mainstream tax for a prior or subsequent year (see Example 4 below); and

(b) if, after attribution of ACT which does not reduce mainstream tax, accumulated profits would not exceed corporate taxes for the year (see Example 5 below).

ACT which reduces mainstream tax in any year or years shall be attributable to any accumulated profits of the year or years for which the mainstream tax is reduced. Where ACT is used to offset mainstream tax, the offset will be viewed as a refund of the ACT initially allowed as a credit and as a tax paid in respect of the year for which the ACT is applied as an offset. Consequently, a reduction paid in respect of the year for which the ACT is applied as an offset. Consequently, a reduction in the foreign tax credit for the year from which the ACT is carried must be made in accordance with section 905(c) of the Code.

Mainstream tax will be considered offset first by ACT incurred with respect to the current distribution. Additional offset will be considered to be attributable to ACT incurred in the earliest year from which the ACT can be carried.

Where attribution to a year of ACT which does not offset mainstream tax leaves no accumulated profits for that year, the more exact attribution method set forth in Example 5 should be used.

2. A distribution in respect of which the ACT paid reduces mainstream tax for the current taxable year may be treated by the Internal Revenue Service as made first out of the entire profits of that year (computed as of the close of the year). This rule, which applies regardless of whether the distribution is made in the first 60 days of the taxable year, will be applied where necessary to prevent crediting of a prior year's mannstream tax unreduced by ACT, while at the same time using such ACT to reduce the current year's mainstream tax.

3. Where a United States corporation owns less than all the stock of a corporation resident in the United Kingdom, the derivative tax credit will be calculated with reference solely to the proportionate interest in accumulated profits attributable to the United States shareholder. Thus, for example, the ratio which the distribution to the United States shareholder bears to accumulated profits in excess of income taxes, as well as the amount of mainstream tax and ACT paid with respect thereto, will be calculated as if the United States shareholder's proportionate interest in the accumulated profits were the entire accumulated profits of a corporation of which it was the sole owner. The amount of foreign tax credit will not vary according to either (1) the status of any other shareholder; or (2) the imposition or refund of ACT with respect to a distribution to any other shareholder.

In the case of dividends paid by a United Kingdom corporation wholly owned by a United States parent corporation, the determination of the appropriate amount of creditable taxes is illustrated by the following examples:

Example 1. A United Kingdom resident corporation wholly owned by a United States parent corporation has $100 of pre-tax earnings in year 1 and pays a dividend equal to 50 percent of the amount available for distribution in year 1.

1. Accumulated profits	$100.00
2. British mainstream tax at 52 pct rate	52.00
3. Available for distribution	48.00
4. Distribution	24.00
5. ACT with respect to distribution before refund	12.92
6. Net mainstream tax, reduced by ACT [1]	39.08
7. Refund of one-half ACT pursuant to paragraph (2) (a) (i) of article 10	6.46
8. Unrefunded one-half of ACT treated as corporate tax pursuant to paragraph (1) (c) of Article 23	6.46
9. Total corporate tax (39.08 mainstream plus 6.46 unfunded ACT)	45.54
10. Total dividend received before withholding tax (24.00 declared plus 6.46 refund treated as dividend pursuant to paragraph (1) (a) (iii) of article 10)	30.46
11. Accumulated profits in excess of British corporate taxes (100–45.54)	54.46

[1] It is assumed in this example, as is generally the case, that ACT is fully credited against mainstream tax.

12. Derivative tax credit $\left(\frac{30.46}{54.46} \times 45.54\right)$	25.47
13. British withholding tax (5 pct of total dividend of 30.46)	1.52
14. Total foreign tax credit	26.99
15. Taxable income (30.46 dividend plus 25.47 "gross-up" of derivative tax credit)	55.93
16. United States tax before credit (48 pct of 55.93)	26.85
17. Amount by which foreign tax credit exceeds United States tax	.14

Example 2. Assume the same facts as in the previous example, except that in year two the British corporation makes a distribution out of what, under United States tax law principles, are the remaining $24.00 of earnings from year one. Assume further that there are no earnings in year two for United Kingdom purposes, and that the ACT with respect to the distribution is carried back and credited against mainstream tax of year 1.

1. Distribution in year "2"	24.00
2. ACT	12.92
3. Reduction in mainstream tax for year "1"	12.92
4. Net mainstream tax for year "1", reduced by ACT	26.06
5 Refund of one-half ACT	6.46
6. Unrefunded ACT	6.46
7. Total corporate tax (26.06 mainstream+6.46 unrefunded ACT in respect of distribution in year "2")	39.08
8. Total dividend received before withholding tax	30.46
9. Accumulated profits in excess of British corporate taxes (100–39.08)	60.92
10. Derivative tax credit $\left(\frac{30.46}{60.92} \times 39.08\right)$	19.54
11. Taxable income (30.46 dividend plus 19.54 "gross-up" of derivative tax credit)	50.00

It should be noted that the total taxable income in respect of the two distributions is $105.93 ($55.93+$50), which is $5.93 more than the accumulated profits of $100; and the total derivative tax credit is $45.01, which is $5.93 more than the corporate tax of $39.08. The disparity occurs for two reasons: first, that the Convention treats refunded ACT as a dividend, but does not treat ACT that is potentially refundable as profits out ow which future dividends can be paid;[1] and second, that $6.46 of the $45.54 mainstream tax considered paid in respect of the accumulated profits in example 1 is subsewuently refunded.

The above result is considered appropriate in order to ensure that, with reference to a 50 percent distribution. the British refund substantially benefits the United States shareholder. An adjustment is necessary, however, when tax which has been taken into account in computing derivative foreign tax credit in respect of a prior distribution—of whatever percentage of the accumulated profits—is refunded in the form of ACT. The refunded ACT must, with respect to such distribution, both (a) increase accumulated profits in excess of income taxes, and (b) decrease taxes paid in respect of accumulated profits.

By reason of the $6.46 refund of ACT in *Example 2*, therefore, the derivative foreign tax credit in *Example 1* must be recalculated as follows;

1. Calculation before adjustment (see (12) of *Example 1*):

$$\frac{30.46}{54.46} \times 45.54;$$

[1] If that were done, the fraction for computing the derivative tax credit in respect of the distribution in example 1 would be

$$\frac{30.46}{54.46+6.46 \text{ potentially refundable ACT or } 60.92} \times \text{taxes paid.}$$

2. Addition of $6.46 to accumulated profits in excess of income taxes:

$$\frac{30.46}{60.92};$$

3. Subtraction of $6.46 from taxes paid: $45.54–6.46=$39.08;
4. Derivative foreign tax credit:

$$\frac{(30.46\times 39.08)}{60.92}=\$19.54.$$

The adjusted result in *Example 1* is the same as in *Example 2*. Both the taxable income and tax credit in respect of the prior distribution will therefore be decreased by $5.93, in accordance with section 905(c) of the Internal Revenue Code.

The determination of the appropriate amount of creditable taxes in the case of dividends paid by a less-wholly-owned United Kingdom corporation is illustrated by the following example:

Example 3. A United Kingdom resident corporation, *W*, is owned by U.S. corporation *X* (25%), U.K. corporation *Y* (60%), corporation *Z* (10%), and individual *A* (5%). *W* has $400 of pre-tax earnings in year 1 and pays a dividend of 50 percent of the amount available for distribution in year, 1. *Z* is organized in country *M* and has no right to receive a refund of ACT from the United Kingdom. *A*, a United Kingdom resident, receives a tax credit equal to the entire ACT imposed, and *Y* makes an election under U.K. law to eliminate ACT with respect to distributions to itself.

1. Accumulated profits	$400.00
2. Mainstream tax imposed at a 52-pct rate	208.00
3. Available for distribution	192.00
4. Total distribution	96.00
5. Portion of accumulated profits attributable to *X*'s shareholding —25 pct	100.00
6. Determination of X's United States foreign tax credit:	
A. Accumulated profits	100.00
B. British mainstream tax at 52-pct rate	52.00
C. Available for distribution	48.00
D. Distribution to United States corporation *X*	24.00
E. For remainder of computation see example 1.	

In the above examples it has been assumed that the earnings and rofits used in calculating the indirect tax credit for United States tax purposes approximate the earnings and profits of the United Kingdom corporation as computed in the United Kingdom for United Kingdom tax purposes. This assumption, of course, is not always valid and there will be situations where the earnings and profits differ for United Kingdom and United States tax purposes. Accordingly, it will be necessary for United States shareholders to maintain separate records to reflect these differences. Such records must currently be maintained by United States shareholders of foreign corporations where the amount of earnings and profits of that corporation differ under the rules of the respective countries. Separate records will be especially important where United States shareholders do not own all of the shares of a United Kingdom corporation. Quite often the shares of a United Kingdom corporation are owned by both United States and foreign shareholders. In these cases, the payment of an ACT credit to the United States shareholder will require a separate computation of earnings and profits for United States tax purposes which reflects that shareholder's proportionate interest in the corporation.

Example 4. A United Kingdom resident corporation is wholly owned by a U.S. corporation. The accumulated profits (according to United States standards), taxable profits (according to United Kingdom standards), and distributions of the subsidiary are as follows:

	Year 1	Year 2	Year 3
1. Accumulated profits	$120	$100	$100
2. Taxable profits	0	50	50
3. Distribution	0	26	130

With respect to year 1, the U.S. parent corporation has no taxable income for U.S. purposes, no U.S. tax, and no foreign tax credit.

As of the end of year 2, the year 2 taxes of the parent are calculated as follows:

1. Accumulated profits	$100.00
2. United Kingdom taxable profits	50.00
3. British mainstream tax at 52 pct rate	26.00
4. Distribution	26.00
5. ACT with respect to distribution before refund	14.00
6. Net mainstream tax, reduced by ACT	12.00
7. Refund of one-half of ACT	7.00
8. Unrefunded one-half of ACT	7.00
9. Total corporate tax ($12 plus $7)	19.00
10. Total dividend received before withholding tax ($26 plus $7)	33.00
11. Accumulated profits in excess of British corportae taxes ($100 minus $19)	81.00
12. Derivative tax credit $\left(\frac{33}{81}\times 19\right)$	7.74
13. British withholding tax (5 pct of $33)	1.65
14. Total foreign tax credit ($7.74 plus $1.65)	9.39
15. Taxable income ($33 plus $7.74)	40.74
16. United States tax before credit (48 pct of $40.74)	19.56
17. United States tax after credit ($19.56 minus $9.39)	10.17

As of the end of year 3, the year 3 taxes are calculated as follows;

	Year 1	Year 2	Year 3
1. Accumulated profits	$120.00	$100.00	$100.00
2. United Kingdom taxable profits	0	50.00	50.00
3. Year "2" United Kingdom corporate tax before year "3" ACT (line 9 above)		19.00	
4. Year "3" British mainstream tax at 52 pct rate			26.00
5. Year "3" ACT before adjustments			70.00
6. Year "3" ACT offset to mainstream tax	0	[1] (3.50)	[1] (17.50)
7. Year "3" ACT carried back and deemed mainstream tax	0	3.50	(3.50)
8. Year "3" ACT refund before adjustment			(35.00)
9. Year "3" ACT refund carried back	0	(1.75)	1.75
10. United Kingdom corporate tax after year "3" ACT (sum of lines 3 through 9)	0	17.25	41.75
11. Accumulated profits in excess of British corporate taxes (line 1 minus line 10)	120.00	82.75	58.25
12. Year "2" dividend		33.00	
13. Accumulated profits available for distribution in year "3" (line 11 minus line 12)	120.00	49.75	58.25
14. Year "3" dividend before sec. 78 gross-up (130+35 ACT refund)			165.00
a. From year "3" accumulated profits (line 13)			58.25
b. From year "2" accumulated profits (line 13)			49.75
c. From year "1" accumulated profits (balance)			57.00
15. Year "3" foreign tax credit:			
a. British withholding tax (5 pct of 165)			8.25
b. Year "3" derivative tax credit (from line 10)			41.75
c. Year "2" derivative tax credit (49.75/82.75×17.25)			10.37
16. Taxable income (165+41.75+10.37)			217.12
17. United States tax before credit (48 pct of 217.12)			104.22
18. Total foreign tax credit (8.25+41.75+10.37)			60.37
19. United States tax after credit (104.22 less 60.37)			43.85

[1] Under United Kingdom rules, the maximum amount of ACT that can be credited against mainstream tax is 35/52 of mainstream tax, and excess ACT is carried back 2 years, and then carried forward indefinitely. Thus, since $26 of mainstream tax was payable for each of years "2" and "3", the offset for ACT for each of years "2" and "3" cannot exceed $17.50 (26×35/52). For year "2", this means an increased offset of $3.50 ($16.50−$14 previously offset).

As of the end of year "3", the year "2" taxes are recalculated as follows:

1. Total dividend received before withholding tax	$33.00
2. British withholding tax (5 pct of 33)	1.65
3. Derivative tax credit (33/81+1.75)×(19−1.75)	6.88
4. Taxable income (33+6.88)	39.88
5. United States tax before credit (48 pct of 39.88)	19.14
6. Total foreign tax credit (1.65+6.88)	8.53
7. United States tax after credit (19.14 minus 8.53)	10.61
8. United States tax previously paid	10.17
9. Additional United States tax due (10.61 minus 10.17)	.44

Example 5. This example, showing a more exact attribution of non-offset ACT, is to be used *only* if, after attribution of non-offset ACT, there are no accumulated profits in excess of British corporate tax.

The facts are the same as in Example 4, except that the accumulated profits for year 3 are $30 rather than $100.

The calculation of the year "2" taxes as of the end of year "2" is the same as in Example 4. As of the end of year "3", the year "3" taxes are calculated as follows:

	Year 1	Year 2	Year 3
1. Accumulated profits	$120.00	$100.00	$30.00
2. United Kingdom taxable profits		50.00	50.00
3. Year "2" United Kingdom corporate tax before year "3" ACT (line 9 of example 4 calculation of year "2" taxes as of the end of year "2")		19.00	
4. Year "3" British mainstream tax at 52 pct rate			26.00
5. Year "3" ACT before adjustments			70.00
6. Year "3" ACT offset to mainstream tax		(3.50)	(17.50)
7. Year "3" ACT carried back and deemed mainstream		3.50	(3.50)
8. Year "3 ACT refund before adjustment			(35.00)
9. Year "3" ACT refund carried back		(1.75)	1.75)
10. United Kingdom corporate tax after year "3" ACT (sum of lines 3 through 9)		17.25	41.75
11. Accumulated profits in excess of British corporate taxes (line 1 minus line 10)	120.00	82.75	(11.75

Since attribution of the non-offset ACT to year 3 eliminates any excess of accumulated profits over British corporate tax, the calculation must be redone, taking into account only offset ACT, and then attributing non-offset unrefunded ACT only to the extent of $17.50 [1] for every $82.50 of accumulated profits considered distributed (determined under U.S. rules before taking into account non-offset ACT).

In year 3, only $17.50 of ACT offsets mainstream tax. One-half of this is refunded. In year 3, therefore, U.K. corporate tax after the offset ACT is:

$$\begin{array}{r} 26.00 \\ (17.50) \\ \hline 8.75 \\ \hline 17.25 \end{array}$$

Accumulated profits in excess of British corporate tax other than non-offset ACT is $30.00 minus $17.25, or $12.75. Non-offset unrefunded ACT is $24.50 $\frac{(70-17.50-3.50)}{2}$. In determining the maximum amount of $24.50 non-offset unrefunded ACT to be attributed to year 3, no ACT should be attributed to deemed distributions, since they do not incur ACT. Thus, of the $12.75, the $8.75 of refunded ACT attributable to the $17.50 offset is excluded from the amount to which unrefunded non-offset ACT is attributable. The maximum amount of non-offset unrefunded ACT attributed to the remaining $4.00 of accumulated profits in year 3 is $0.85. The $0.85 is calculated as $\frac{17.5}{82.5}\times 4.00$.

[1] $17.50 represents the amount of unrefunded ACT which would result from an actual distribution of $65 one-half of 65\times\frac{35}{65}$. With an actual distribution of $65, the $17.50 of refunded ACT would be deemed distributed, thus increasing the total distribution to $82.50.

Thus, of the $12.75, $8.75 is deemed distributed as refunded offset ACT; $0.85 is unrefunded offset ACT; $0.85 is refunded offset ACT deemed distributed, and $2.30 is the remaining actual distribution considered to have been made from year 3.

In year 2, the accumulated profits available for distribution before adjustment for year 3 non-offset ACT are $49.75 (from line 13 of Example 4 calculation of year 3 taxes). Of that amount, $8.75 is deemed distributed as refunded offset ACT. The unrefunded non-offset ACT attributable to the remaining $41.00 is $8.73 ($41.00$\times\frac{17.5)}{82.5}$. Thus, the accumulated profits available for distribution in year 2 are $32.21 ($49.75 less $8.75 and $8.73); and the U.K. corporate tax is $25.98 ($17.25+$8.73).

A similar attribution procedure is followed in attributing ACT to distributions from year 1.

The carryback of non-offset unrefunded ACT is limited to two years, and there is no carryforward.

Paragraph (2) of this Article parallels paragraph (1) with respect to the treatment of United States taxes paid by a resident of the United Kingdom. Under this paragraph, the United Kingdom will allow a resident of the United Kingdom as a credit against United Kingdom taxes paid to the United States in accordance with the provisions of the law of the United Kingdom for the allowance of credits for taxes to territories outside the United Kingdom (as it may be amended from time to time without changing the general principle of paragraph (2)). Such credit shall be allowed with respect to taxes payable in accordance with this Convention on profits or income from sources within the United States, as determined by subparagraph (3) of this Article (excluding, in the case of a dividend, tax payable in respect of the profits out of which the dividend is paid).

In the case of a dividend paid by a United States corporation to a corporation which is a resident of the United Kingdom which controls directly or indirectly 10 percent or more of the voting power of that paying corporation, the United Kingdom shall also allow a credit for the appropriate amount of taxes paid or accrued to the United States by the United States corporation paying such dividends with respect to the profits out of which such dividends are paid.

Paragraph (3) sets forth the source of income rules applicable for purposes of determining the allowance of tax credits under this Article. For purposes of the preceding paragraphs, income or profits derived by a resident of a Contracting State which are taxed in the other Contracting State in accordance with the Convention (other than by reason of the saving clause referred to below) shall be deemed to a rise from sources within that other Contracting State. However, where a United States citizen is subject to tax in the United States by reason of his citizenship under the saving clause of paragraph (3) of Article 1 (Personal Scope), the United Kingdom will allow that person a tax credit for any United States tax paid with respect to income which under the internal laws of the United Kingdom has its source in the United States; and the United States will allow that person, subject to limitations of the Internal Revenue Code to claim a credit for taxes paid to the United Kingdom with respect to income which under the internal laws of the United States has its source in the United Kingdom. This paragraph has particular relevance with respect to a United States citizen who is a resident of the United Kingdom for purposes of this Convention (see Article 4 (Fiscal Residence)).

In the case of third country income earned by a United States citizen who is a resident of the United Kingdom, (e.g., dividends from Germany), the United Kingdom is not required to allow a credit for United States taxes on that income. Double taxation of income may be avoided, however, under the overall method for computing foreign tax credits. In such case, the United States will allow under its internal law a credit for both the United Kingdom and third country taxes.

Finally, paragraph (4) makes it clear that the credit allowed for taxes paid to the United Kingdom, especially the petroleum revenue tax, shall be subject to the tax credit limitations of the Tax Reduction Act of 1975 which apply to foreign oil and gas extraction income.

Paragraph (2) provides that one Contracting State will give the other Contracting State limited assistance in collecting its taxes. Thus, each Contracting State is required to collect on behalf of the other Contracting State only those taxes imposed by such other Contracting State as will ensure that any exemption or reduced rate of tax granted under this Convention by such other Contracting State is not enjoyed by persons not entitled to such benefits.

Paragraph (3) makes clear that a Contracting State is not obligated to carry out measures which are at variance with its laws or the administrative practice with respect to the collection of its own taxes; or which would be contrary to its sovereignty, security or public policy. A Contracting State may also consider, in determining the administrative measures it will use, the administrative measures utilized by the other Contracting State in a comparable situation.

Paragraph (4) provides that the competent authorities will consult to cooperate and advise each other on the implementation of these provisions.

ARTICLE 27. EFFECT OF DIPLOMATIC AND CONSULAR OFFICIALS AND DOMESTIC LAWS

Paragraph (1) of this Article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements.

Paragraph (2) provides that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State. This rule reflects the principle that a Convention should not increase the tax burden on residents of the Contracting States.

ARTICLE 28. ENTRY INTO FORCE

Paragraph (1) provides that the proposed Convention shall be ratified and that the instruments of ratification shall be exchanged at Washington, D.C. as soon as possible after both States have ratified the Convention.

Paragraph (2) provides that the Convention will enter into force on the thirty-first day following the date of exchange of the instruments of ratification. With respect to the United Kingdom, the proposed Convention will take effect in the following manner. In relation to any dividend to which subparagraph (2)(a)(ii) of Article 10 (Dividends) applies, the provisions of that Article shall apply to any year of assessment beginning on or after April 6, 1973. For this purpose, a dividend paid on or after April 1, 1973, and before April 6, 1973, shall be treated for tax credit purposes (i.e., for purposes of any refund of the ACT) as paid on April 6, 1973. United States shareholders who derived dividends from corporations which were residents of the United Kingdom during this period will be entitled to claim refunds from the United Kingdom in respect of those dividends and in accordance with the provisions of paragraph 2(a)(ii) of Article 10. It is anticipated that the United Kingdom will prescribe the procedures for claiming those refunds upon ratification of this Convention.

In the case of dividends to which subparagraph (2)(a)(i) of Article 10 (Dividends) applies (i.e., dividends received from a corporation which is a resident of the United Kingdom by a United States corporation owning 10 percent or more of the voting stock thereof), and any other provision of the Convention in respect of income tax and payments of tax credits (i.e., refunds of ACT), and in respect of the United Kingdom capital gains tax, those provisions shall be effective for any year of assessment beginning on or after April 6, 1975. Refunds of tax may be claimed in the manner to be prescribed by the United Kingdom.

The Convention will be effective in respect of the United Kingdom corporation tax, for any financial year beginning on or after April 1, 1975, in respect of the United Kingdom petroleum revenue tax, for any chargeable period beginning on or after January 1, 1975, and (in accord with Article V of the Protocol of ----------, 1977) in respect of the special domicile rule of paragraph (4) of Article 4 (Fiscal Residence) for any year of assessment beginning on or after April 6, 1976.

For the United States, tax credits for taxes paid to the United Kingdom on or after April 1, 1973, shall be allowed for the period subsequent to that date in accordance with paragraph (1) of Article 23 (Elimination of Double Taxation). In the case of dividends received for any year of assessment beginning on or after April 6, 1973, and before any year of assessment beginning on

or after April 6, 1975, by a United States corporation described by paragraph (2)(a)(i) of Article 10 (Dividends), the full amount of ACT paid in respect of such dividends shall be regarded as a tax imposed on the distributing corporation.

With respect to taxes withheld at source, this Convention shall become effective in the United States on January 1, 1975, for taxes withheld on or after that date and with respect to all other taxes, this Convention will be effective in the United States for taxable years beginning on or after January 1, 1975.

Subject to the provisions of paragraph (4) of this Article, the 1945 Convention, as amended by the Supplementary Protocol of June 6, 1946, by the Supplementary Protocol of May 25, 1954, by the Supplementary Protocol of August 19, 1957, and by the Supplementary Protocol of March 17, 1966, will cease to have effect in respect of taxes to which this Convention in accordance with the provisions of paragraph (2) of this Article applies.

Where any provision of the 1945 Convention would have afforded any greater relief from tax, any such provision will continue to have effect for any year of assessment or financial year in the United Kingdom and for any taxable year in the United States beginning, in either case, before January 1, 1976.

The 1945 Convention will terminate on the last date on which it has effect in accordance with the foregoing provisions of this Article. In addition, this Convention will not affect any Agreement in force extending the 1945 Convention in accordance with Article XXII thereof. In those cases, the 1945 Convention will continue to apply to those territories. The United States has requested the United Kingdom to advise territories to which the 1945 Convention has been extended that the United States desires to renegotiate the Convention as it affects those territories so as to reflect the principles of this Convention.

The amendments to this Convention effected by the Notes exchanged at London on April 13, 1976 shall enter into force on the same date as determined under paragraph (2) of this Article and, in accord with the provisions of Article V of the Protocol of August 26, 1976 and of Article VI of the Protocol of _____, 1977, the amendments to this Convention effected by those protocols shall, upon ratification, enter into force on the thirty-first day following the date of the exchange of the instruments of ratification of those Protocols. Once in force, the provisions of the Notes and the two protocols shall have effect in accordance with this Article.

ARTICLE 29. TERMINATION

This Article is drafted in substantially the same manner as the termination Article of the 1945 Convention.

Paragraph (1) provides that the Convention will remain in force indefinitely, but that either Contracting State may, on or before June 30 in any year after the year 1980, give to the other Contracting State through diplomatic channels notice of termination. When notice is properly given, the Convention ceases to be effective for taxable years beginning on or after January 1 of the following year for United States tax; for a year of assessment beginning on or after April 6 of the following year for United Kingdom income tax and capital gains tax; for a financial year beginning on or after April 1 of the following year for United Kingdom corporation tax; and for a chargeable period beginning on or after January 1 of the following year for United Kingdom petroleum revenue tax.

Under paragraph (2), the termination of the proposed Convention will not have the effect of reviving any treaty or arrangement abrogated by the present Convention or by treaties previously concluded between the Contracting States.

TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE REPUBLIC OF THE PHILIPPINES FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME SIGNED AT MANILA ON OCTOBER 1, 1976

ARTICLE 1. TAXES COVERED

Paragraph (1) designates the taxes of the Contracting States which are subject to the Convention. With respect to the United States, the subject taxes are the Federal income taxes imposed by the Internal Revenue Code ("Code"),

ARTICLE 24. NON-DISCRIMINATION

Paragraph (1) provides that individuals who are nationals of a Contracting State and who are residents of the other Contracting State will not be subjected in that other Contracting State to taxation or any other requirement connected therewith which is other or more burdensome than the taxation or requirements connected therewith to which nationals of that other Contracting State in the same circumstances are or may be subjected. Thus, for example, a national of the United Kingdom who is a resident of the United States and who meets the requirements specified in Code section 911 would, under this Article, be entitled to the benefits of that section even though he is not also a national of the United States. On the other hand, just as a United States citizen who becomes a non-resident alien at any time during a taxable year or whose spouse is a non-resident alien cannot in the absence of an election file a joint return for that year, a United Kingdom national would not be entitled to file a joint return with his spouse in the absence of such election if either is a non-resident alien at any time during the taxable year.

Paragraph (2) provides that a permanent establishment which an enterprise of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to less favorable taxation than an enterprise of that other Contracting State carrying on the same activities.

Subject to the provisions of paragraph (4), discussed below, paragraph (3) provides that interest, royalties, and other disbursements paid by an enterprise of a Contracting State to an enterprise of the other Contracting State shall, if reasonable in amount, be deductible for purposes of determining the taxable profits of the enterprise in that Contracting State under the same conditions as if they had been paid to a resident of that Contracting State. This rule is not limited to payments to related parties.

For purposes of this paragraph, the term "other disbursements" includes charges for amounts expended by a resident of the other Contracting State for the benefit of the enterprise. The term "other disbursements" is to be broadly defined, to include charges or allocations by such resident for the benefit of such enterprise, including reasonable allocations of executive and general administrative overhead (except to the extent such expenses are not for the benefit of the enterprise, but are for "stewardship" or "overseeing" functions for the resident's own benefit as an investor in the enterprise). The term also includes charges and allocations of research and development expenses where the enterprise has the benefits of such activities under a cost or risk sharing agreement and other expenditures by the resident of a group of enterprises which includes such enterprise.

Paragraph (4) states that paragraph (3), above, does not apply to interest, royalties, or other disbursements to which the provisions of Article 9 (Associated Enterprises), paragraphs (5) and (7) of Article 11 (Interest), or paragraph (5) of Article 12 (Royalties) apply with respect to transactions between related parties.

Paragraph (5) prohibits one Contracting State from subjecting an enterprise of such Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, to any taxation or any requirement connected with taxation which is other or more burdensome than is applicable to enterprises of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of the first-mentioned Contracting State.

Paragraph (6) provides that nothing in this Article obliges a Contracting State to grant to individual residents of the other Contracting State any personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

This Article is similar to Article XXI of the 1945 Convention and Article 24 (Non-Discrimination) of the OECD Model Convention.

ARTICLE 25. MUTUAL AGREEMENT PROCEDURE

This Article generally extends the mutual agreement procedures found in Article XXA of the 1945 Convention and is similar to Article 25 (Mutual Agreement Procedure) of the OECD Model Convention.

Under paragraph (1), when a resident or national of a Contracting State considers that the actions of one or both Contracting States results or will result in taxation which is not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of those States, present his case to the competent authority of the Contracting State of which he is a resident or national. A resident or national of a Contracting State need not, although it is anticipated that in the normal situation he will, exhaust his other administrative or judicial remedies prior to resorting to the use of the mutual agreement procedure.

Under paragraph (2), if the claim is considered to be justified by the competent authority and if it cannot alone arrive at an appropriate solution to the issue involved, that competent authority shall endeavor to resolve the case by agreement with the competent authority of the other Contracting State, wih a view to the avoidance of taxation which is contrary to the Convention. In cases in which the competent authorities reach an agreement, taxes will be imposed, and refunds or credits of taxes will be allowed, as appropriate, by the Contracting States in accordance with such agreement. In the case of the United States, where an agreement is reached between the competent authorities which requires the United States to make a refund of tax or to extend any other similar credit, such refund or credit will be made, assuming presentation of his case to the competent authority within a reasonable period, notwithstanding any procedural barriers otherwise existing under United States law, including any statute of limitations. In cases where an agreement cannot be reached between the competent authorities, the United States will not be required to provide any relief for double taxation on a unilateral basis.

Paragraph (3) permits the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may reach agreement on the attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State; the allocation of income, deductions, credits, or allowances between persons; the nature of particular items of income; the meaning of terms not otherwise defined in this Convention; the place where a particular item of income has its source; and the elimination of double taxation in respect of income paid out of trusts. In the case of trust distributions, the competent authorities may conclude that elimination of double taxation requires that the character of the income giving rise to such distributions must be determined. In such a case, taxpayers will be expected to have the records necessary to demonstrate the character of income underlying a trust distribution.

Under paragraph (4), the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions, for the purpose of reaching an agreement.

ARTICLE 26. EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

This Article extends without change the exchange of information Article (Article XX) and the assistance in collection Article (Article XIXA) of the 1945 Convention.

Paragraph (1) provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information necessary for the carrying out of the Convention and of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is in accordance with the Convention. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes. Information need be exchanged, however, only if it is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

The information exchanged must be treated as secret. However, such information may be disclosed to any persons or authorities (including a court or administrative body) concerned with the assessment, collection, or enforcement of, or prosecution with respect to, the taxes which are the subject of the Convention. No information may be exchanged which would disclose any trade, business, industrial or professional secret or any trade process.

but not including sections 531 (accumulated earnings tax) and 541 (personal holding company tax). The term "Federal income taxes" includes the taxes imposed under section 1401 (tax on self-employment income) and under sections 3101 and 3111 (Federal Insurance Contributions Act taxes) with respect to the employee's share of the tax. The employer's share of the tax is not regarded as an income tax and, accordingly, it is not covered by this paragraph. The Convention only applies to taxes on income contained in the Internal Revenue Code. Thus, the Convention does not, for example, apply to the excise tax under Code section 1491.

In the case of the Philippines, paragraph (1) provides that the Convention applies to the income tax imposed by Title II of the National Internal Revenue Code ("Philippine Code"), but not including taxes imposed under sections 25 (additional tax on improperly accumulated earnings) and 63 (personal holding company tax).

Pursuant to paragraph (2), the Convention will also apply to taxes substantially similar to those covered by paragraph (1) which are imposed in addition to, or in place of, existing income taxes, after October 1, 1976, (the date of signature of the Convention).

Paragraph (3) provides that the competent authority of each Contracting State will notify the competent authority of the other Contracting State of any amendment of the tax laws referred to in paragraph (1) or (2), and of the adoption of substantially similar taxes imposed in addition to, or in place of, the taxes referred to in paragraph (1), by transmitting the texts of such amendments or statutes at least once a year. Paragraph (4) provides for a similar annual exchange with respect to the publication of material concerning the application of the Convention, whether in the form of regulations, rulings or judicial decisions.

ARTICLE 2. GENERAL DEFINITIONS

Paragraph (1) sets out definitions of certain basic terms used in the Convention. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the Convention. It should be noted that a number of important terms are defined elsewhere in the Convention.

The term "United States" means the United States of America. When used in the geographical sense, the term means the states of the United States and the District of Columbia. Thus, the Convention does not apply to the possessions of the United States or the Commonwealth of Puerto Rico. The term "United States" also includes the territorial sea and, as provided in section 638 of the Code, the continental shelf of the United States. The term "Philippines" means the Republic of the Philippines. When used in a geographical sense, the term means the territory comprising the Republic of the Philippines.

The term "Contracting State" is defined to mean the United States or the Philippines as the context requires.

The term "person" includes an individual, a partnership, or corporation, an estate or a trust.

The term "United States corporation" is defined as a corporation, or any unincorporated entity which is treated as a corporation for United States tax purposes, which is created or organized in or under the laws of the United States, any state thereof, or the District of Columbia. A "Philippine corporation" is defined as a corporation, or any unincorporated entity which is treated as a corporation for Philippine tax purposes, which is created or organized in the Philippines or under its laws. Under section 84(b) of the Philippine Code, the term "corporation" includes partnerships, no matter how created or organized, other than general professional partnerships. A general professional partnership is formed for the sole purpose of exercising a common profession, no part of the income of which is derived from engaging in a trade or business. Thus, a partnership formed in the United States which is engaged in a trade or business in the Philippines is considered to be a corporation for Philippine tax purposes. Nonetheless, for purposes of the Treaty, that partnership will not be considered to be a Philippine corporation within the meaning of paragraph (1)(e)(ii) since it was not created or organized in or under the laws of the Philippines.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to the Philippines, it means the Secretary of Finance or his delegate. The term "tax" means those taxes imposed by the United States or the Philippines to which the Convention applies by virtue of Article 1 (Taxes Covered). However, as provided in paragraph (4) of Article 24 (Nondiscrimination), the term "taxes" or "taxation"

means, for purposes of that article, taxes or taxation of every kind imposed at the national, state, or local level.

The term "international traffic" is defined as any transport by a ship or aircraft operated by a resident of one of the Contracting States except where such transport is confined solely between places within a Contracting State. Thus, for example, coastal shipping along the Atlantic coast of the United States is not international traffic. However, if a ship operated by a resident of the Philippines transports goods from Canada to the United States, leaving some of the goods in San Francisco and the remainder in San Diego, the portion of the voyage between San Francisco and San Diego is international traffic.

Paragraph (2) provides that any term used in the Convention which is not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined. However, where a term has a different meaning under the laws of the Philippines and the United States or where the meaning under the laws of one of the Contracting States is not readily determinable, the competent authorities may for purposes of the Convention establish a common meaning in order to prevent double taxation or to further any other purpose of the Convention.

ARTICLE 3. FISCAL RESIDENCE

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. Residence is important because, in general, only a resident of one of the Contracting States may qualify for the benefits of the Convention.

Under paragraph (1), the term "resident of the Philippines" means a Philippine corporation (as defined in Article 2 (General Definitions)) or any other person (except a corporation or any entity treated as a corporation for Philippine tax purposes) resident in the Philippines for purposes of Philippine tax. Thus, for example, a partnership formed in the United States which engages in a trade or business in the Philippines and is treated as a corporation under Philippine tax law is not a resident of the Philippines. It does not meet the condition of paragraph (1)(a)(i) since it is not a Philippine corporation as defined in Article 2 and it does not meet the condition of paragraph 1(a)(ii) since it is an entity treated as a corporation for Philippine tax purposes. Under paragraph (1) of Article 6 (General Rules of Taxation), such a partnership may be taxed by the Philippines only on income from sources therein, to the extent the partnership is treated as a resident of the United States under paragraph (1)(b)(ii). Similarly "resident of the United States" means a United States corporation (as defined in Article 2) and any other person (except a corporation or any entity treated as a corporation for United States tax purposes) resident in the United States for purposes of United States tax. Thus, a resident of the United States includes a resident alien individual who is subject to tax in the United States on his worldwide income and a resident citizen, but under no circumstances, a foreign corporation.

A citizen of the United States or the Philippines is not automatically a resident of the United States or the Philippines for purposes of this Convention. An individual's residence is determined on the basis of whether the individual is treated as a resident for tax purposes by a Contracting State. An individual who is a resident of both Contracting States will be deemed to be a resident of the Contracting State in which he has his permanent home, his center of vital interests (closest personal and economic relations), a habitual abode, or his citizenship, in the order listed. If the issue is not settled by these tests, the competent authorities will decide by mutual agreement the one Contracting State of which he will be considered to be a resident.

The Convention provides that a partnership, estate or trust, in the case of the United States, and a professional partnership, estate, or trust, in the case of the Philippines, is a resident of the applicable Contracting State only to the extent that the income derived by such person is subject to tax in such Contracting State as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the Convention, in the case of the United States income received by a partnership, estate, or trust will not qualify for the benefits of the Convention unless such income is subject to tax in the United States as the income of a resident. Thus, for United States tax purposes, the treatment of income received by a partnership will be determined by the residence and taxation of its partners with respect to that income rather than by whether the partnership is

resident in the United States by engaging in a trade or business here. To the extent the income of the partners is subject to United States tax as the income of residents of the United States, the partnership will be treated as a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

The fact that a charitable trust or pension fund is exempt from tax in the country in which it is otherwise resident is not to be construed to deny such exempt trust or fund resident status under this Convention.

ARTICLE 4. SOURCE OF INCOME

This Article contains the source rules which are to be used in applying the provisions of the Convention. For example, under Article 6 (General Rules of Taxation), one Contracting State may tax a resident of the other Contracting State only on income sources within the first-mentioned Contracting State (provided such resident is not a citizen of the first-mentioned Contracting State).

Paragraph (1) provides that, as a general rule, dividends will be treated as income from sources within a Contracting State if paid by a corporation of that Contracting State or if paid by a corporation of any State, provided that, in the latter case, at least 50 percent of such corporation's gross income from all sources for the 3-year period (or such part of that period as the corporation has been in existence) ending with the close of its taxable year preceding the declaration of the dividends was business profits attributable to a permanent establishment which such corporation had in that Contracting State. In such a case, only a pro rata portion of the dividend will be treated as income from sources within the applicable Contracting State. Such portion is the amount which bears the same ratio to the dividends as the amount of the business profits attributable to the permanent establishment bears to the corporation's gross income. If a dividend would be treated under paragraph (1) as income from sources within both Contracting States, the pro rata portion of the dividend which is deemed to be from sources within the Contracting State in which the permanent establishment is situated is considered to be from sources only within that Contracting State. The remaining portion of the dividend, if any, shall be considered to be from sources within the other State.

A counterpart to the dividend source rule of the Convention appears in Code section 861(a)(2)(B). However, under Code section 864(c)(4), only four types of income from sources outside the United States—certain rents, royalties, or gains on sales of intangible property; certain dividends or interest, or gains or losses from sales of securities in connection with certain banking, finance and security trading businesses; certain sales of goods or merchandise through an office in the United States; and, certain income received by foreign life insurance companies—can be considered to be effectively connected with the conduct of a trade or business within the United States. If, for example, the business profits of a permanent establishment maintained by a Philippine corporation is comprised entirely of income from sources outside the United States not specified in Code section 864(c)(4), the United States will not tax a dividend paid by the Philippine corporation even if more than 50 percent of that corporation's gross income is attributable to the permanent establishment. The United States foregoes its right to tax in such circumstances. Under paragraph (2) of Article 6 (General Rules of Taxation), the Convention will not increase a person's United States tax.

Under paragraph (2) of Article 4, interest will be treated as income from sources within a Contracting State only if paid by the Contracting State, a political subdivision or local authority thereof, or by a resident of that Contracting State. The one exception to this rule is that if interest is paid on an indebtedness incurred in connection with a permanent establishment which bears such interest, then such interest shall be deemed to be from sources within the State (whether or not a Contracting State) in which the permanent establishment is situated. This exception permits a Contracting State, under the proper circumstances, to impose a tax on interest borne by a permanent establishment therein, including a permanent establishment of a resident of a State other than a Contracting State. For example, if a resident of France has a permanent establishment in the Philippines which borrows money from a resident of the United States and bears the interest, the interest will be deemed to be from sources within the Philippines. However, the United States will not, because of Article 6

(General Rules of Taxation) and Code section 861 (a)(1)(C) and (D), impose a tax on interest received by nonresident alien individuals of foreign corporations from a foreign corporation having a permanent establishment in the United States unless 50 percent or more of the gross income of such corporation from all sources for the 3-year period ending with the close of its taxable year preceding the payment of the interest (or such part of such period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States. Even where the United States imposes a tax, no tax will be imposed on the portion of such interest which bears the same ratio to the total amount of the interest as the gross income of the corporation which was not effectively connected with the conduct of a trade or business in the United States bears to that corporation's gross income from all sources.

In addition, the permanent establishment exception to the general source rule for interest will exempt interest from tax in the Contracting State in which the payor resides if the payor has a permanent establishment in a State other than a Contracting State in connection with which the indebtedness of which the interest is paid was incurred, such interest is borne by the permanent establishment and such interest is paid to a resident of the other Contracting State. This results, once again, from the restriction in paragraph (1) of Article 6 (General Rules of Taxation) that a resident of one Contracting State, not a citizen of the other Contracting State, may be taxed by the other Contracting State only on income from sources within that other Contracting State. For example, if a resident of the United States has a permanent establishment in France which borrows money from a resident of the Philippines and bears the interest, the interest will be deemed to be from French sources, even if paid by the United States resident. Thus, the United States may not tax such income unless the recipient-resident of the Philippines is a citizen of the United States or has a permanent establishment in the U.S. to which the income is attributable. The rules of Article 5 (Permanent Establishment) will be applied to determine whether the resident of the United States has a permanent establishment in France.

Paragraph (3) provides that royalties for the use of, or the right to use, property or rights will be treated as income from sources within a Contracting State only to the extent that such royalties are for the use of, or the right to use, such property or rights within that Contracting State. However, if a royalty is paid with respect to a liability to pay the royalty that was incurred in connection with a permanent establishment which bears that royalty, then such royalty shall be deemed to be from sources within the State (whether or not a Contracting State) in which the permanent establishment is situated. It is intended that such exception will be applied in a manner similar to the exception with respect to interest. However, the United States will not, because of Code sections 861(a)(4) and 862(a)(4), impose a tax on royalties received by nonresident aliens or foreign corporations from a foreign corporation having a permanent establishment in the United States except to the extent that the royalties are for the use of, or the privilege of using, the property in the United States or the recipient of the royalties is engaged in the active conduct of a business in the United States so that Code section 864(c)(4)(B)(i) applies.

Paragraph (4) provides that income (including royalties) to which Article 7 (Income from Real Property) applies will be treated as income from sources within a Contracting State only if the real property is situated in that Contracting State.

Under paragraph (5), income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, will be treated as income from sources within a Contracting State only to the extent that such services are performed in that Contracting State. However, income from personal services performed abroad ships or aircraft operated by a resident of a Contracting State in international traffic will be treated as income from sources within that Contracting State if rendered by a member of the regular complement of that ship or aircraft. Notwithstanding the general rule and the above described exception, remuneration described in Article 20 (Governmental Functions) and payments described in Article 19 (Social Security Payments) paid from the public funds of a Contracting State or a political subdivision or local authority thereof will be treated as income from sources within that Contracting State only.

Paragraph (6) contains a general qualification to the preceding source rules. It provides that business profits attributable to a permanent establishment which the recipient, a resident of one Contracting State, has in the other Contracting State will be treated as income from sources within that other Contracting State. Business profits attributable to such permanent establishment may include any item of income described in paragraphs (1) through (4) if the item of income is effectively connected with the permanent establishment. See the discussion of paragraph (6) of Article 8 (Business Profits) for a discussion of the "effectively connected" concept.

Under paragraph (7), gross revenues from the operation of ships or aircraft in international traffic will be treated as from sources within a Contracting State to the extent the revenues are derived from outgoing traffic originating in that State. Thus, for example, gross revenues derived from transporting passengers and freight from Manila to Hawaii, non-stop aboard an airplane, are deemed to be derived from sources within the Philippines for purposes of the Convention.

Under paragraph (8), the source of any item of income not described in the preceding paragraphs of Article 4 will be determined by each Contracting State in accordance with its own law. However, if the source of any such item of income under the laws of one Contracting State is different from its source under the laws of the other Contracting State or if its source is not readily determinable under the laws of one of the Contracting States, the competent authorities of the Contracting States may, in order to prevent double taxation or further any other purpose of the Convention, establish a common source of the item of income for purposes of the Convention.

As mentioned previously, several of the source rules set out in this Article differ to some degree from those provided in the Code. Since paragraphs (2) of Article 6 (General Rules of Taxation) provides that the Convention will not increase a person's United States tax, a taxpayer is entitled to use the more beneficial of the Code rules or the Convention rules in calculating his United States tax.

ARTICLE 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment." The existence of a permanent establishment is relevant under Article 8 (Business Profits) to the taxation of business profits and in determining the applicability of other provisions of the Convention.

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which a resident of one of the Contracting States engages in a trade or business. Illustrations in paragraph (2) of a permanent establishment include a seat of management; a branch; an office; a store or other sales outlet; a factory; a workshop; a warehouse; a mine, quarry or other place of extraction of natural resources; a building site or construction or assembly project of supervisory activities in connection therewith, provided the site, project, or activity continues for a period of more than 183 days; and, the furnishing of services, including consultancy services, by a resident of one Contracting State through employees or other personnel, provided activities of that nature continue (for the same or a connected project) within the other Contracting State for a period or periods aggregating more than 183 days. Under the building site or construction or assembly project or supervisory activities rule, the 183-day period begins only when work physically commences in the other Contracting State. For purposes of that rule, a series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project when applying the 183-day test. In that respect, it is similar to the furnishing services rule.

As a general rule, any fixed facility or premises through which a resident engages in a trade or business for an indefinite or substantial period of time will be treated as a permanent establishment unless it is used only for one or more of the activities described in paragraph (3). Paragraph (3) specifically provides that a permanent establishment does not include a fixed place of business if it is used only for one or more of the following:

(*a*) The use of facilities solely for the purpose of storage, display, or occasional delivery of goods or merchandise belonging to the resident;

(*b*) The maintenance of a stock of goods or merchandise belonging to the resident solely for the purpose of storage, display, or occasional delivery;

(*c*) The maintenance of a stock of goods or merchandise belonging to the resident solely for the purpose of processing by another person;

(*d*) The maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the resident;

(*e*) The maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the resident; or

(*f*) The furnishing of services, including the provision of equipment, in one of the Contracting States by a resident of the other Contracting State, including consultancy firms, in accordance with, or in the implementation of, an agreement between the Contracting States regarding technical cooperation. Such an agreement was signed at Manila on April 27, 1951. See Economic and Technical Cooperation Agreement with the Philippines, April 27, 1951, [1952] 3 U.S.T. 3707, T.I.A.S. 2498.

As noted, these exceptions are cumulative and a fixed place of business used only for one or more of these purposes and will not be considered a permanent establishment under the Convention. It is intended that a building site or construction or assembly project or supervisory activity in connection therewith which does not exist for more than 183 days does not constitute a permanent establishment.

Under paragraph (4), a person acting in one Contracting State on behalf of a resident of the other Contracting State, other than an agent of an independent status to whom paragraph (5) applies, will be deemed to constitute a permanent establishment if such person has, and habitually exercise in that first-mentioned Contracting State, an authority to conclude contracts in the name of the resident, unless the exercise of the authority is limited to the purchase of goods or merchandise for the resident. Even if the person has no authority to conclude contracts in the name of the resident, he will be deemed to constitute a permanent establishment if he habitually maintains in the first-mentioned Contracting State a stock of goods or merchandise from which he regularly delivers goods and merchandise on behalf of the resident. Similar rules appear in Code section 864(c)(5)(A).

On the other hand, paragraph (5) provides that a resident of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such resident carries on business in such other Contracting State through a broker, general commission agent, or any other agent of an independent status, where such broker or agent is acting in the ordinary course of his business. However, if the activities of the agent are devoted wholly or almost wholly on behalf of that resident and the transactions between the agent and the resident are not made under arm's length conditions, the agent will not be considered to be an agent of independent status within the meaning of paragraph (5). Thus, for example, an agent will not lose his status as an independent agent merely because he acts exclusively or almost exclusively for a resident of the other Contracting State. Nor will an agent lose his status as an independent agent merely because he enters into transactions with the resident under non-arm's length conditions. However, where both such conditions exist, the agent, in effect, is no longer independent and paragraph (5) reflects that fact. Similar rules apply under Code section 864(c)(5)(A)(ii). Regulations section 1.864–7(d)(3)(iii) indicates that an otherwise independent agent who acts exclusively or almost exclusively for one foreign principal may not be considered to be an agent of independent status in appropriate circumstances.

Paragraph (6) provides that, except with respect to reinsurance, a resident of a Contracting State will be deemed to have a permanent establishment in the other Contracting State if it collects premiums in that other Contracting State, or insures risks situated therein, through an employee or representative situated therein who is not an agent of independent status to whom paragraph (5) applies. A similar provision appears in the existing United States Convention with France.

Paragraph (7) provides that a resident of one Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident sells at the termination of a trade fair or convention. The trade fair exception is not intended to apply with respect to other goods in the resident's inventory. This exception appears in recent United States conventions.

Under paragraph (8), the fact that a corporation of one of the Contracting States controls or is controlled by or is under common control with a corpora-

tion of the other Contracting State or a corporation which carries on business in that other Contracting State (whether through a permanent establishment or otherwise) will not be taken into account in determining whether the activities or fixed place of business of either corporation constitutes a permanent establishment of the other corporation.

Paragraph (9) provides that the principles set forth in this Article are to be applied in determining whether there is a permanent establishment in a State other than one of the Contracting States or whether a person other than a resident of one of the Contracting States has a permanent establishment in one of the Contracting States. This is necessary for the proper application of paragraphs (2) and (3) of Article 4 (Source of Income). This paragraph is not intended to extend the benefits of the Convention to persons other than residents of the two Contracting States.

ARTICLE 6. GENERAL RULES OF TAXATION

Under paragraph (1), a resident of one Contracting State may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income, subject to the limitations set forth in the Convention. For this purpose, the sources rules contained in Article 4 (Source of Income) are to be applied. However, if the resident is a citizen of the other Contracting State, that Contracting State may tax the resident without regard to this paragraph because of the saving clause of paragraph (3).

Paragraph (2) contains the customary rule that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of tax imposed by it, or by any other agreement between the Contracting States. This rule reflects the principle that a convention should not increase the tax burden on residents of the Contracting States.

Paragraph (3) contains the traditional savings clause under which the United States reserves the right to tax its citizens and residents as if the Convention had not come into effect. However, because of paragraph (4), the savings clause does not apply in several cases in which its application would contravene policies reflected in the Convention which are specifically designed to extend treaty benefits to citizens or residents. Thus, the saving clause does not affect the provisions with respect to social security payments, relief from double taxation, nondiscrimination, or the mutual agreement procedure. Moreover, the saving clause does not affect the benefits of the Convention which are conferred upon individuals performing governmental functions, teachers, students, trainees, and diplomatic or consular officers who are neither citizens of, nor have immigration status in, the Contracting State conferring such benefits. In the case of the United States, "immigrant status" means the individual has been admitted to the United States for permanent residence. The saving clause is reciprocal.

Paragraph (5) authorizes the competent authorities of the Contracting States to prescribe regulations necessary to carry out the provisions of the Convention. On the United States side, this authority is also provided by Code section 7805.

ARTICLE 7. INCOME FROM REAL PROPERTY

Under paragraph (1), income from real property, including royalties and other payments in respect of the exploitaition of natural resources (e.g., oil wells), and gains from the alienation (sale, exchange or other disposition) of such property or of the right giving rise to such royalties or other payments may be taxed by the Contracting State in which the real property or natural resources are situated. For purposes of the Convention, interest on indebtedness secured by real property (e.g., mortgages) or secured by a right giving rise to royalties or other payments in respect of the exploitation of natural resources are not considered as income from real property.

Under paragraph (2), paragraph (1) applies to income derived from the usufruct, direct use, letting, or use in any other form of real property.

ARTICLE 8. BUSINESS PROFITS

Paragraph (1) sets forth the general rule that business profits of a resident of one Contracting State are exempt from tax by the other Contracting State unless the resident has a permanent establishment in the other Contracting

State. Where there is a permanent establishment, only the business profits attributable to the permanent establishment can be taxed by that other Contracting State, unless the resident is a citizen of that other Contracting State. (See the saving clause in paragraph (3) of Article 6 (General Rules of Taxation).) Under paragraph (6) of Article 4 (Source of Income), business profits whether from sources within or without a Contracting State attributable to a permanent establishment which a resident of one Contracting State has in the other Contracting State will be considered to be from sources within that other Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code attributable to a permanent establishment situated in the United States will be subject to tax by the United States.

In determining the proper attribution of business profits under the Convention, paragraph (2) provides that both Contracting States will attribute to the permanent establishment such profits as it would reasonably be expected to derive if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident of which it is a permanent establishment. Paragraph (3) embellishes on that rule by providing that business profits derived from the sale of goods or merchandise of the same or similar kind as those sold, or from other business activities of the same or similar kind as those effected, through that permanent establishment, may be attributable to that permanent establishment if the sale or activities had been resorted to in order to avoid taxation.

Under paragraph (4), expenses, wherever incurred, which are reasonably allocable to business profits attributable to the permanent establishment, including executive and general administrative expenses, will be allowed as deductions in determining the business profits of the permanent establishment. However, in determining the amount of the deduction under paragraph (4) for expenses incurred by the head office, the deduction may be limited to the expense incurred without including the profit element for the head office. Moreover, no deductions will be allowed in respect of amounts paid or payable (other than reimbursement of actual expenses) by the permanent establishment to any office of the resident by way of royalties, fees, or other similar payments in return for the use of patents or other rights; commissions for specific services performed or for management; and, except for banking institutions, interest on money lent to the permanent establishment.

Paragraph (5) provides that no profits shall be attributed to a permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment for the account of such resident of which it is a permanent establishment. Paragraph (2) does not override paragraph (5). Thus, where a permanent establishment purchases goods for its head office, the business profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a notional figure for profits from purchasing.

Under paragraph (6), the term "business profits" means income derived from any trade or business whether carried on by an individual, corporation, or any other person, or group of persons, including the rental of tangible personal (movable) property. The term "business profits" also includes income from dividends, interest, and royalties, but only if the income is effectively connected with a permanent establishment. See paragraph (4) of Article 11 (Dividends), paragraph (5) of Article 12 (Interest) and paragraph (4) of Article 13 (Royalties).

The Convention contains no criteria for determining whether income is effectivly connected with a permanent establishment. However, the "effectively connected" concept in the Convention is substantially similar to the "effectively connected" concept in section 864(c) of the Code. It is intended that the factors which apply under that Code section will apply with respect to this Convention.

Under paragraph (7), where business profits include items of income which are dealt with separately in other articles of the Convention, the provisions of those articles will not be affected by the provisions of this Article. Thus, for example, taxation of interest income will be controlled by Article 12 (Interest) and not by this Article. If the interest is effectively connected with a permanent establishment, paragraph (5) of Article 12 provides that this Article will apply.

ARTICLE 9. SHIPPING AND AIR TRANSPORT

Article 9 permits a Contracting State to impose a tax on the profits derived from sources therein by a resident of the other Contracting State from the operation of ships or aircraft in international traffic. In so providing, it departs from the shipping and air transport traffc article which customarily appears in income tax conventions of the United States.

Under Paragraph (1), profits derived by a resident of one Contracting State from sources within the other Contracting State from the operation of ships in international traffic may be taxed by both Contracting States. However, a limitation is placed on the amount of tax which may be imposed by the country of source. The tax imposed by the country of source, the "other Contracting State," may be as much as, but shall not exceed 1.5 percent of the gross revenues derived from sources in that State (as determined under paragraph (7) of Article 4 (Source of Income)) or the lowest rate of Philippine tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third State, whichever is less. Under that formula, for example, a Philippine corporation which operates ships between Manila and Hawaii and which engages in no other trade or business will determine its United States income tax in the following manner. First, it will compute a tentative tax under Code section 882 on the taxable income which is effectively connected with the conduct of its trade or business within the United States, using the source rule which appears in Code section 863. Then, it will compute the limitation under paragraph (1) by multiplying its gross revenues from United States sources, using the source rule which appears in paragraph (7) of Article 4 (Source of Income), by 1.5 percent. The lower of those two figures is its United States income tax. The reciprocal exemptions of Code sections 872(b) and 883(a) do not apply to Philippine residents because the Philippines imposes a tax on the earnings of foreign carriers in the amount of 2.5 percent of their gross Philippine billings.

Paragraph (2) states that nothing in the Convention affects the right of a Contracting State to tax, under its domestic laws, profits derived by a resident of the other Contracting State from sources within the first-mentioned Contracting State from the operation of aircraft in international traffic. Thus, although the United States and the Republic of the Philippines have placed a limitation in the Convention on the taxation of income from the operation of ships in international traffic, they have not agreed to such a provision with respect to income derived from the operation of aircraft in international traffic. Such income will be taxed in accordance with the tax legislation of each of the Contracting States.

The tax under paragraphs (1) and (2) may be imposed notwithstanding any other provisions of the Convention, including Article 24, a permanent establishment which a resident of one Contracting State has in the other Contracting State will not be subject in the other Contracting State to more burdensome taxes than a resident of that other Contracting State carrying on the same activities.

It is possible that, under this Article, United States residents operating ships and aircraft in international traffic may be subject to more burdensome taxation in the Philippines than Philippine corporations. For example, Philippine air carriers, other than Philippine Air Lines, and shipping companies enjoy recurring 10-year exemptions from Philippine income tax on income derived from international traffic. Philippine Air Lines is subject to a franchise tax of 2 percent of gross income in lieu of all Philippine taxes. Should the President find that, with respect to profits from the operation of ships or aircraft in international traffic, United States citizens or corporations are being subjected to a higher effective rate of Philippine tax than are Philippine citizens, residents, or corporations, Articles 9 and 24 do not prevent the adjustment of United States income tax under Code section 896.

Paragraph (3) provides that paragraphs (1) and (2) apply to profits derived from the participation in a pool, a joint business venture, or in an international operating agency.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, a Contracting State may tax income from international traffic derived by a resident of the other Contracting State without regard to this Article if such resident is a citizen of the first-mentioned Contracting State.

ARTICLE 10. RELATED PERSONS

This Article confirms the authority of the United States under section 482 of the Code. Thus, where a person subject to the taxing jurisdiction of a Contracting State (whether or not a resident thereof) and any other related person make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, under paragraph (1), any income, deductions, credits or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income or loss of, or the tax payable by, one of such persons, may be taken into account in computing the amount of the income subject to tax and the taxes payable by such person in that Contracting State.

Paragraph (2) sets forth an explicit formulation of the consequence of a redetermination made in accordance with paragraph (1) by a Contracting State to the income of one of its residents. In such event, the other Contracting State will, if it agrees with such redetermination and if necessary to prevent double taxation, make a corresponding adjustment to the income of a person in such other Contracting State related to such resident. In the case of the United States, any refunds of tax in respect of such an adjustment shall be made notwithstanding the statute of limitations. In situations where the other Contracting State disagrees with the redetermination, the two Contracting States will endeavor to reach agreement in accordance with the mutual agreement procedure in paragraph (2) of Article 25 (Mutual Agreement Procedure). For a discussion of the mutual agreement procedure and a fuller explanation of the operation of the statute of limitations with respect to adjustments see the discussion under Article 25.

Paragraph (3) provides that for purposes of the Convention a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both. "Control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

ARTICLE 11. DIVIDENDS

Paragraph (1) provides that dividends derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both Contracting States. However, paragraph (2) limits the rate of tax imposed by the Contracting State of source to a rate not in excess of 25 percent of the gross amount of the dividends. If the dividend recipient is a corporation, the rate of tax imposed by the Contracting State of source may not exceed 20 percent of the gross amount of the dividend if during the part of the paying corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year (if any), at least 10 percent of the outstanding voting stock of the paying corporation was owned by the recipient corporation. These rate limitations do not affect the taxation of profits of the corporation which pays the dividends.

Paragraph (3) provides that dividends paid by a corporation of one of the Contracting States to a person other than a citizen or resident of the other Contracting State may be taxed by that other Contracting State only in limited circumstances. Such other Contracting State may impose tax if the dividends are treated as income from sources in that State under paragraph (1)(b) of Article 4 (Source of Income), but only on the portion of the dividend which is deemed to be income from sources within the other Contracting State. Moreover, the Philippines may only tax such a dividend if the Philippine branch profits tax described in paragraph (6) has not been paid with respect to the earnings distributed. In addition, the other Contracting State may impose tax if the recipient of the dividend has a permanent establishment or a fixed base in the State and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base.

Paragraph (4) provides that the limitations of paragraph (2) shall not apply if the recipient of the dividends derived from sources within a Contracting State, being a resident of the other Contracting State, carries on business in the first-mentioned Contracting State through a permanent establishment situated therein or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed

base. In such a case, the dividends shall be treated as business profits subject to the provisions of Article 8 (Business Profits) or income from the performance of independent personal services subject to the provisions of Article 15 (Independent Personal Services), as the case may be. If the recipient of the dividend is a citizen or resident of the source Contracting State, that Contracting State may tax the recipient without regard to this Article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Paragraph (5) provides that the term "dividends" as used in the Convention means income from shares, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the taxation law of the State of which the corporation making the distribution is a resident.

Paragraph (6) relates to the Philippine branch profits tax. Under section 24(b)(2) of the Philippine Code, the Philippines imposes a tax of 20 percent upon profits which are remitted outside the Philippines by a Philippine branch office to its mother company. Paragraph (6) preserves the right of the Philippines to impose such a branch profits tax by providing that nothing in the Convention will be construed to prevent the Philippines from imposing on the earnings of a corporation (other than a Philippine corporation) attributable to a permanent establishment in the Philippines, a tax in addition to the tax which would be chargeable on the earnings of a Philippine corporation. Such Philippine branch profits tax will not exceed 20 percent of the amount of such earnings which have not been subjected to such additional tax in previous taxable years, and in accordance with Philippine law, will only be imposed when such earnings are remitted outside the Philippines. The term "earnings" means, for purposes of paragraph (6), business profits attributable to a permanent establishment for the year in issue and all previous years after deducting therefrom all Philippine tax imposed thereon other than the Philippine branch profits tax.

ARTICLE 12. INTEREST

Paragraph (1) provides that interest derived by a resident of one Contracting State may be taxed by both Contracting States. However, the rate of tax in the Contracting State of source is limited by paragraph (2) to a rate not in excess of 15 percent of the gross amount of the interest and, if the interest is derived with respect to public issues of bonded indebtedness, by paragraph (3) to a rate not in excess of 10 percent of the gross amount of the interest.

Paragraph (4) provides that interest beneficially derived by one of the Contracting States, or by an instrumentality of that Contracting State, will be exempt from tax by the other Contracting State. Under this rule, interest income derived by the Central Bank of the Philippines, the Federal Reserve Banks of the United States, the Export-Import Bank of the United States, the Overseas Private Investment Corporation (OPIC), and such other institutions of either Contracting State as the competent authorities may determine by mutual agreement on loans made to residents of the other Contracting State will be exempt from tax in that other State. The exemption also applies where a resident of a Contracting State receives interest income with respect to debt obligations guaranteed or insured by that Contracting State or an instrumentality thereof.

Paragraph (5) provides that the reduced rate of tax under paragraphs (2) and (3) and the exemption under paragraph (4) will not apply if the recipient of interest from sources within one Contracting State, being a resident of the other Contracting State carries on business through a permanent establishment situated therein or performs in that other State independent personal services from a fixed base situated therein and the debt claim in respect of which the interest is paid is effectively connected with such permanent establishment or fixed base. In such a case, the interest will be treated as business profits subject to the provisions of Article 8 (Business Profits) or income from the performance of independent personal services subject to the provisions of Article 15 (Independent Personal Services), as the case may be.

If excessive interest is paid to a related person, paragraph (6) provides that this Article does not apply to the excessive portion of the payment. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. In the case of the United States, the excessive portion may be taxed as a dividend, in which case the provisions of Article 11 (Dividends) will apply.

Paragraph (7) defines interest for purposes of the Convention as income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits. In particular, the term "interest" includes income from government securities and income from bonds or debentures, including premiums and prizes attached to such bonds, debentures or government securities and other income (such as original issue discount) which under the taxation laws of the Contracting State in which the income arises is assimilated to income from money lent.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, interest derived by a citizen or resident of the source Contracting State may be taxed by that Contracting State without regard to this Article.

ARTICLE 13. ROYALTIES

Paragraph (1) provides that royalties derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, the rate of tax imposed by that other Contracting State on such royalties is limited under paragraph (2). If the royalties are derived from sources within the United States, the United States tax is limited to a rate which does not exceed 15 percent of the gross amount of those royalties. On the other hand, if the royalties are derived from sources within the Philippines, the tax is subject to three limitations. In general, the Philippine tax is limited to a rate which does not exceed 25 percent of the gross amount of the royalties. However, if the royalties are paid by a corporation registered with the Philippine Board of Investments and engaged in preferred areas of activity, the tax is limited to a rate which does not exceed 15 percent of the gross amount of the royalties. Notwithstanding such 25 percent and 15 percent limitations, the Philippine tax cannot exceed the lowest rate of Philippine tax that may be imposed on royalties of the same kind under similar circumstances to a resident of a third State. Thus, for example, because the Philippines agreed to limit its tax on film royalties to an amount not in excess of 10 percent of the gross amount of such royalties in its Income Tax Conventions with Sweden and Denmark, that limitation will apply to film royalties paid under similar circumstances to United States residents. Of course, if those 10-percent limitations are renegotiated upward by the Philippines the limitation with respect to the tax on United States residents will be affected. However, under paragraph (2) of Article 29 (Entry Into Force), such third-described limitation with respect to the tax on royalties will not have effect with respect to payments for the use of, or the right to use, a copyright of cinematographic films or films or tapes used for radio or television broadcasting until January 1, 1979.

The term "royalties" is defined in paragraph (3) as payments of any kind made as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including copyrights of cinematographic films or films or tapes used for radio or television broadcasting, any patent, trademark, design, model, plan, secret process or formula, or other like right or property, or information concerning industrial, commercial, or scientific experience (know-how). The term "royalties" also includes gains derived from the sale, exchange, or other disposition of any such right or property which are contingent on the productivity, use, or disposition of any such right or property which are contingent on the productivity, use, or disposition thereof. If the amounts realized are not so contingent, the provisions of Article 14 (Capital Gains) may apply.

Paragraph (4) provides that the tax rate limitations of paragraph (2) shall not apply if the recipient of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein, or performs in that other State professional services from a fixed base situated therein, and the right or property in respect to which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case, the royalties will be treated as business profits subject to Article 8 (Business Profits) or income from the performance of independent personal services subject to tax under Article 15 (Independent Personal Services).

If excessive royalties are paid to a related person, paragraph (5) provides that this Article does not apply to the excessive portion of the royalty. The

excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. Thus, in the case of the United States, the excessive portion may be treated as a dividend or interest, or in whatever other manner is appropriate.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, royalties derived by a citizen or resident of the source Contracting State may be taxed by that Contracting State without regard to this Article.

ARTICLE 14. CAPITAL GAINS

This Article sets forth the circumstances in which gains derived by a resident of one Contracting State may be taxed by the other Contracting State.

Under paragraph (1), gains from the alienation of tangible personal (movable) property forming part of the business property of a permanent establishment which a resident of a Contracting State has in the other Contracting State or gains from the sale of tangible personal (movable) property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including gains from the alienation of the permanent establishment (along or together with the whole enterprise) or the fixed base, may be taxed in that other State. However, gains derived by a resident of a Contracting State from the alienation of ships, aircraft or containers operated by such resident in international traffic will only be subject to tax in the State of the operator's residence, notwithstanding the fact that profits derived by such resident from sources within the other Contracting State from the operation of such ships or aircraft may be taxed by both States under Article 9 (Shipping and Air Transport). Gains which are considered to be royalties under paragraph (3) of Article 13 (Royalties) will only be taxed in accordance with the provisions of Article 13.

Paragraph (2) provides that gains from the alienation of any property other than those mentioned in paragraph (1) or those mentioned in Article 7 (Real Property) will only be taxed in the Contracting State of which the alienator is a resident.

If the recipient of the gain is a resident of one Contracting State and a citizen of the other Contracting State, that other Contracting State may tax the recipient without regard to this Article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

ARTICLE 15. INDEPENDENT PERSONAL SERVICES

In dealing with the taxation of income from personal services, the Convention distinguishes between "independent" and "dependent" personal services. The Convention also provides special treatment with respect to individuals who are public entertainers.

Under paragraph (1), income derived by an individual resident of one Contracting State from the performance of personal services in an independent capacity may be taxed only by that Contracting State. However, under paragraph (2), such income derived from services performed in the other Contracting State may also be taxed in that other Contracting State in certain circumstances. Thus, if the individual has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities, he may be taxed by that State, but only on the income that is attributable to that fixed base (the term fixed base is synonymous with the term "permanent establishment" as described in Article 5 (Permanent Establishment)). Similarly, if the individual is present in the other Contracting State for a period or periods aggregating 90 days or more in the taxable year, he may be taxed by that State. Finally, if the gross remuneration derived in the taxable year from residents of the other Contracting State for the performance of personal services in an individual capacity in that other Contracting State exceeds $10,000 or its equivalent in Philippine pesos that other Contracting State may tax the income of that individual from the performance of those services. Since the $10,000 is gross remuneration, it includes any expenses, such as airfare, borne on behalf of or reimbursed to the individual performing the personal services. Article 15 also provides that the competent authorities may specify in an exchange of letters that the $10,000 limitation will be increased if circumstances warrant, i.e., if

inflation reduces the real value of $10,000. Once increased, the limitation can be decreased by the competent authorities, but never to an amount less than $10,000.

Paragraph (3) makes clear that the other Contracting State referred to in paragraph (2) may impose its tax only on net income.

Under the saving clause of paragraph (3) of Article 6 (General Rules of Taxation), the other Contracting State may also tax any individual who is a citizen or resident of that other Contracting State without regard to this Article.

Personal services performed by an individual in an independent capacity are services performed for his own account where he receives the income and bears the losses arising from such services. If an individual is an independent contractor, he is considered to perform personal services in an independent capacity. Income from services in which capital is a material income-producing factor, however, will generally be governed by the provisions of Article 7 (Business Profits). Generally, the term "personal services in an independent capacity" includes, but is not limited to, services rendered as a director of a corporation or rendered by physicians, lawyers, engineers, architects, dentists, and accountants performing personal services as sole proprietors or partners. Services performed by employees, such as by an officer of a corporation, are dependent personal services to which Article 16 (Dependent Personal Services) applies.

ARTICLE 16. DEPENDENT PERSONAL SERVICES

This Article deals with the taxation in respect of dependent personal services. This Article is similar in many respects to Article 15 (Dependent Personal Services) of the OECD Model Convention. Under paragraph (1), wages, salaries, and similar remuneration derived by an individual who is a resident of one Contracting State from labor or personal services performed as an employee, including income for services performed by an officer of a corporation, may be taxed by that Contracting State, except as provided in Article 20 (Governmental Functions). In addition, except as provided by paragraphs (2) and (3) and in Articles 20 (Governmental Functions), 21 (Teachers), and 22 (Students and Trainees), remuneration from the performance of dependent personal services derived from sources within the other Contracting State may be taxed by that other Contracting State.

Under paragraph (2), dependent personal service income derived by an individual resident of one Contracting State will be exempt from tax by the other Contracting State if: (a) the individual is present in that other Contracting State for a period or periods aggregating less than 90 days in the taxable year; (b) the individual is an employee of a resident of the first-mentioned Contracting State or of a permanent establishment maintained in the first-mentioned Contracting State; and (c) the remuneration is not borne as such by a permanent establishment or fixed base which the employer has in the other Contracting State. Such income, however, may also be taxed by that other Contracting State without regard to this Article if the individual is a citizen or resident of that other Contracting State, because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

In the United States, remuneration from the performance of dependent services will be viewed as not having been borne by the permanent establishment or fixed base maintained in the United States if the employee is performing stewardship or overseeing functions for the benefit of a resident of or a permanent establishment maintained in the Philippines. However, the remuneration will be considered to be borne by the permanent establishment or fixed base maintained in the United States if the remuneration is paid for activities other than stewardship or overseeing functions and the permanent establishment or fixed base is entitled to claim the employee's remuneration as a deduction in computing taxable income for United States purposes because the remuneration is definitely related and allocable to its gross income or a class of its gross income pursuant to Code section 861 and the regulations thereunder.

Paragraph (3) provides that, notwithstanding the provisions of paragraphs (2) and (3), remuneration derived by an employee (even if a resident of a State other than a Contracting State) of a resident of one Contracting State for labor or personal services performed as a member of the regular complement of a ship or aircraft operated in international traffic by a resident of that Contracting State may be taxed only by that Contracting State.

ARTICLE 17. ARTISTES AND ATHLETES

This Article deals with the taxation of income derived by public entertainers and athletes (sometimes referred to as "artistes and athletes") in respect of the performance of services as such in a Contracting State. The Article applies in cases where an artiste or athlete performs services on his own behalf and in cases where services are performed on behalf of another person, as an employee or pursuant to any other arrangement.

Paragraph (1) states the general rule that notwithstanding the provisions of Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services), income derived by public entertainers such as theater, motion picture, radio, or television artistes, and musicians, and by athletes, from their personal activities as such, may be taxed in the Contracting State where those activities are exercised. Such income, however, is taxable under this Article only where it exceeds $100 or its equivalent in Philippine pesos per day or exceeds in the aggregate $3,000 or its equivalent in Philippine pesos during the taxable year.

As noted above, this paragraph overrides the provisions of Articles 15 and 16, so that an artiste or athlete may be taxed in the State where his activities take place regardless of the period of time he is present in that State. Generally, however, income derived from services rendered by producers, directors, technicians and others who are not artistes and athletes is taxable in accordance with the provisions of Article 15 or 16, as the case may be.

Paragraph (2) deals with cases where income in respect of the activities of an entertainer or athlete accrues to a person other than, or in addition to, the entertainer or athlete. It is based on paragraph (2) of Article 17 (Artistes and Athletes) of the OECD Model Convention and a counterpart is found in recent United States conventions with the United Kingdom, Japan, Trinidad and Tobago, and Iceland. A common method employed by foreign entertainers is to perform services in the United States as an employee of or a contractor for a corporation or other person. That person may act as the nominal recipient of the income in respect of the entertainer's services and the entertainer may act as its "employee" or "contractor." In such cases, the corporation may escape taxation in respect of those services by reason by Article 8 (Business Profits) because it does not have a permanent establishment in the United States described under Article 5 (Permanent Establishment). The entertainer may also escape taxation by receiving a small salary while in the United States and by receiving payment in a later year when the income is subject to reduced rates of tax or no tax at all, or by liquidating the corporation after the services are performed.

Paragraph (2) is designed to deal with these situations by providing that where income in respect of the personal activities of an artiste or athlete accrues to the benefit of another person (including a corporation, trust, or partnership of either Contracting State or any third State), that income may, notwithstanding the provisions of Articles 8 (Business Profits), 15 (Independent Personal Services), and 16 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised. Thus, for example, such other person could not claim the permanent establishment protection provided by Articles 5 (Permanent Establishment) and 8 (Business Profits).

For purposes of paragraph (2), income is considered to accrue to the benefit of another person where that other person has control over or the right to gross income derived in respect of an entertainer's or athlete's services as such. This rule applies regardless of whether the other person is a "sham" corporation or conduit. However, income will not be deemed to accrue to the benefit of another person where it is established to the satisfaction of the competent authority of the Contracting State where the services are performed that neither the entertainer or athlete, nor persons related thereto, participate directly or indirectly in the profits of such other person or receive any benefit from such profits. Persons may be considered to be related to the artiste or athlete regardless of whether the persons are considered to be related under the provisions of paragraph (3) of Article 10 (Related Persons). For this purpose, a person may be considered to be related to the artiste or athlete if he is an employee or agent of the artiste or athlete, or if he is regularly employed by the artiste or athlete in an advisory capacity, such as his attorney, accountant, or investment advisor. An artiste or athlete will be considered to participate in the profits of the other person if he received, or is entitled to receive, deferred

compensation, bonuses, fees, dividends, partnership or other distributions from that person or the proceeds from the sale or disposition of an interest in that person during the year in which services are performed, or in any subsequent year.

Paragraph (3) provides that, notwithstanding the provisions of paragraph (1) and Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services), income derived from activities performed in a Contracting State by public entertainers or athletes will be exempt from tax in that Contracting State if the visit to that State is substantially supported or sponsored by the other Contracting State and the public entertainer or athlete is certified as qualified under this provision by the competent authority of the sending State. Under this provision, for example, Philippine folk dance troupe performers would be exempt from tax in the United States if their visit is substantially supported or sponsored by the Philippine Government and the Secretary of Finance of the Philippines or his delegate certifies those performers as qualified for exemption.

ARTICLE 18. PRIVATE PENSIONS AND ANNUITIES

Except as provided in Article 20 (Governmental Functions), pensions and other similar remuneration paid to an individual will be taxable under paragraph (1) only in the Contracting State where the service is rendered. Thus, private pensions and similar remuneration derived from sources within one Contracting State by an individual resident of the other Contracting State may be taxed in the first-mentioned Contracting State. The term "pensions and other similar remuneration" is defined in paragraph (4) to include any periodic payments, other than payments covered in Article 19 (Social Security Payments), made by reason of retirement or death and in consideration for services rendered, or by way of compensation for injuries or sickness received in connection with past employment. Thus, where payments are considered to be pensions or similar remuneration under the laws of one of the Contracting States, such payments will be considered to be pensions or similar remuneration for purposes of paragraph (1), subject to an agreement to the contrary by the competent authorities acting under paragraph (2) of Article 2 (General Definitions) to prevent double taxation or to further any other purpose of the Convention. Thus, for example, for United States tax purposes, distributions from independent retirement accounts would be considered to be pensions or similar remuneration to which paragraph (1) applies. On the other hand, the term pension does not include, for United States tax purposes, payments in respect of the cancellation or premature termination of employment contracts (e.g., "golden handshakes" or severance pay). Such payments are taxable under the provisions of Articles 15 (Independent Personal Services), 16 (Dependent Personal Services) or 17 (Artistes and Athletes).

Paragraph (2) provides that annuities paid to an individual resident of a Contracting State will be taxable only in that Contracting State. The term "annuities" is defined in paragraph (5) as a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligaton to make the payments in return for adequate and full consideration (other than for services rendered).

Paragraph (3) provides that child support payments made by an individual resident of one Contracting State to an individual resident of the other Contracting State will be exempt from tax in that other Contracting State. The term "child support payments" is defined in paragraph (6) as periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, individuals who are citizens or residents of a Contracting State may be taxed by that Contracting State without regard to this Article.

ARTICLE 19. SOCIAL SECURITY PAYMENTS

This Article provides that social security payments and other public pensions, e.g., railroad retirement benefits, paid by one Contracting State to an individual who is a resident of the other Contracting State (or, in the case of such payments by the Philippines, to an individual who is a citizen of the United

States) will be taxable only in the first-mentioned Contracting State. Payments described in Article 20 (Governmental Functions) are not covered by this Article.

ARTICLE 20. GOVERNMENTAL FUNCTIONS

Under this Article, wages, salaries, and similar remuneration, including pensions, annuities, or similar benefits, paid from public funds of one Contracting State to a citizen of that Contracting State, or to a citizen of a State other than a Contracting State who comes to the other Contracting State expressly for the purpose of being employed by the first-mentioned Contracting State, for labor or personal services performed as an employee of the national government of that Contracting State, or any agency thereof, in the discharge of functions of a governmental nature will be exempt from tax by the other Contracting State. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation). Remuneration or pensions paid in respect of services rendered in connection with any trade or business carried on by one of the Contracting States or any agency thereof will be treated the same as compensation received from a private employer, and the provisions of Articles 15 (Independent Personal Services), 16 (Dependent Personal Services) and 18 (Private Pensions and Annuities), as the case may be, will apply.

This Article applies only to remuneration paid out of public funds by the national government of a Contracting State or its agencies.

ARTICLE 21. TEACHERS

Paragraph (1) provides that, if a resident of one Contracting State is invited by the other Contracting State, a political subdivision or local authority thereof, or by a university or other recognized educational institution in that other Contracting State to come to the other Contracting State for a period not expected to exceed 2 years for the purpose of teaching or engaging in research, or both, at a university or other recognized educational institution, and if such resident comes to that other Contracting State primarily for such purpose, his income from personal services for teaching or research at such university or educational institution will be exempt from tax by that other Contracting State for period not exceeding 2 years from the date of his arrival in that other Contracting State.

Since a temporary visit may be of such a duration that an individual may lose his status as a resident of the Contracting State of which he was a resident at the time he became eligible for the benefits of this Article, the individual need only be a resident of such Contracting State at the beginning of his visit. However, if the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation). If the individual's visit exceeds a period of 2 years from the date of his arrival, the exemption applies only to the income received by the individual before the expiration of such 2-year period. However, if the period of the visit had been expected to exceed two years then the exemption does not apply to any of the income earned. However, if an individual who otherwise meets the requirements of this Article expects to visit for a period of two years for the purpose of teaching and for a subsequent period of, for example, two years for purposes described in paragraph (1) of Article 22 (Student and Trainees), then pursuant to paragraph (4) of Article 22 the exemption provided by this Article does apply.

A person who visits a Contracting State for the purposes explained in this Article and meets the qualifications contained in its may again claim its benefits if he first reestablishes his residence in the other Contracting State. In such a case, the person claiming these benefits on a subsequent occasion must first satisfy the competent authority of the first-mentioned Contracting State that he had become a bona fide resident of the other Contracting State for a substantial period of time.

Pursuant to paragraph (2), this Article does not apply to income from research undertaken not in the general interest (i.e., public interest) but primarily for the private benefit of a specific person or persons other than the

person performing the research. For example, research projects which are undertaken to discover or perfect product processes, designs, etc., which are expected to be commercially exploited by the researcher or his present (or former) employer do not qualify under this Article.

ARTICLE 22. STUDENTS AND TRAINEES

Paragraph (1) provides that an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for the primary purpose of studying at a university or other recognized educational institution, securing training required to qualify him to practice a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization, will be exempt from tax by that other Contracting State, with respect to certain amounts, for a period not exceeding 5 taxable years from the date of his arrival in that other Contracting State. The amounts exempted under this provision are gifts from abroad for the purposes of his maintenance, education, study, research or training; the grant, allowance, or award; and, income from personal services performed in the other Contracting State not in excess of $3,000 (or its equivalent in Philippine pesos) for any taxable year. For United States tax purposes, gifts will be considered to be from abroad when they are borne by a person who is not a resident (as defined in Article 3 (Fiscal Domicile)) of the United States.

Under paragraph (2), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein as an employee of, or under contract with, a resident of the first-mentioned Contracting State, for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned Contracting State or other than a person related to such resident, or studying at a university or other recognized educational institution in that other Contracting State, will be exempt from tax by that other Contracting State for a period of not exceeding 12 consecutive months, on income from personal services not in excess of $7,500 or its equivalent in Philippine pesos for any taxable year.

Under paragraph (3), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for a period not exceeding 1 year, as a participant in a program sponsored by the government of the other Contracting State, for the primary purpose of training, research, or study, will be exempt from tax by the other Contracting State with respect to his income from personal services in respect of such training, research, or study performed in that other Contracting State in an aggregate amount not in excess of $10,000 or its equivalent in Philippine pesos for any taxable year.

The monetary limits provided in paragraphs (1), (2), or (3) are in addition to, and not in lieu of, other exemptions provided by the Code. Thus, an unmarried resident of the Philippines who is temporarily present in the United States for the primary purpose of studying at a university would be entitled to exclude $3,000 of income from the performance of personal services (if he is present in the United States for periods totaling less than 90 days during the taxable year) and, in addition, would be entitled to the personal exemption allowed by section 151 of the Code, as provided in section 873(b) of the Code.

In comparison to paragraph (2)(c) of Article 15 (Independent Personal Services), which provides that the competent authorities may agree in an exchange of letters to a monetary limitation in excess of $10,000 or its equivalent in Philippine pesos, the monetary limitations of paragraphs (1), (2), and (3) cannot be increased by means of an exchange of letters between the competent authorities.

The first sentence of paragraph (4) provides that the benefits provided in paragraph (1) for certain students, trainees and researchers and the benefits provided under Article 21 (Teachers), when taken together, may extend only for such period of time, not to exceed 5 taxable years from the date of the individual's arrival, as may reasonably or customarily be required to effectuate the purpose of the visit. The second sentence of paragraph (4) makes it clear that the benefits provided by Article 21 (Teachers) will not be available to an individual if, during the immediately preceding period, the individual enjoyed

the benefits provided by paragraph (1). Thus, a Philippine individual who originally entered the United States for the purpose of becoming a student and received benefits under paragraph (1) must leave the United States and re-establish residence in the Philippines before he can obtain the benefits of Article 21. In such a case, the person claiming the benefits of Article 21 on a subsequent occasion must first satisfy the competent authority of the United States that he had become a bona fide resident of the Philippines for a substantial period of time. In addition, the individual must, of course, meet the requirements of paragraph (1) of Article 21, viz., he must return at the invitation of the United States, a political subdivision or local authority thereof, or a university or other recognized educational institution for the primary purpose of becoming a teacher, etc.

If an individual qualifies for the benefits of more than one of the provisions of this Article, such individual may choose the most favorable provision but may not claim the benefits of more than one provision in any taxable year as a means of avoiding the limitation provided. Thus, for example, an individual who comes to the other Contracting State for the primary purpose of studying may be able to qualify under either paragraph (2) or (3) of this Article. However, he cannot combine the maximum exclusion limits in those two paragraphs to exclude $17,500 during the taxable year. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, the other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation).

ARTICLE 23. RELIEF FROM DOUBLE TAXATION

In order to avoid double taxation, each Contracting State agrees in this Article to provide to its citizens or residents a credit against its taxes for taxes paid by such persons to the other Contracting State.

The United States agrees to allow a United States citizen or resident as a credit against United States tax the appropriate amount of taxes paid or accrued to the Philippines in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle of paragraph (1)). In addition, in the case of a United States corporation owning at least 10 percent of the voting stock of a Philippine corporation from which it receives dividends in any taxable year, the United States will allow credit for the appropriate amount of taxes paid or accrued to the Philippines by the Philippine corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to the Philippines but the credit is not to exceed the limitations (for the purpose of limiting the credit to the United States tax on incomes from sources within the Philippines or on income from sources outside of the United States) provided by United States law for the taxable year. This provision does not require the United States to provide a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect. For the purpose of applying the United States credit in relation to taxes paid or accrued to the Philippines, the rules set forth in Article 4 (Source of Income) will be applied to determine the source of income, and the taxes referred to in paragraphs (1)(b) and (2) of Article 1 (Taxes Covered) will be considered to be income taxes.

Paragraph (2) provides the general rule that the Philippines will allow a Philippine citizen or resident as a credit against Philippine tax the appropriate amount of income taxes paid or accrued to the United States and, in the case of a Philippine corporation owning at least 50 percent of the voting stock of a United States corporation from which it receives dividends in any taxable year, will also allow credit for the appropriate amount of taxes paid or accrued to the United States by the United States corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to the United States but will not exceed the limitations (for the purpose of limiting the credit to the Philippine tax on income from sources within the United States and on income from sources outside the Philippines) provided by Philippine law for the taxable year. Under section 30(c)(4) of the Philippine Code, the Philippine foreign tax credit is subject to both the per-country and overall limitations. Of course, the Philippines are not obligated to retain such limitations as long as the principle of a foreign tax credit is retained. For the purpose of applying

the Philippine credit in relation to taxes paid or accrued to the United States, the rules set for in Article 4 (Source of Income) will be applied to determine the source of income and the taxes referred to in paragraphs (1)(a) and (2) of Article 1 (Taxes Covered) will be considered to be income taxes.

The general rule of paragraph (2), that citizens of the Philippines will be given a credit against Philippine tax for income taxes paid or accrued to the United States, is subject to an exception contained in an Exchange of Notes between the Governments of the Philippines and the United States dated November 24, 1976. In that Exchange of Notes, it was agreed that so long as the Philippines Government taxes the worldwide income of Philippine citizens residing outside the Philippines at reduced rates of 1, 2, or 3 percent, the Philippine Government may give a deduction rather than a credit to those citizens for U.S. taxes paid. It was also agreed that in the event that those rates are increased, Article 23 would require the Philippine Government to grant their nonresident citizens a foreign tax credit for U.S. taxes.

ARTICLE 24. DISCRIMINATION

This Article sets forth the general rules prohibiting discriminatory taxation of residents and corporations of one Contracting State by the other Contracting State. It also reserves to the Philippines the right to limit to its citizens or corporations certain tax incentives in carefully limited circumstances described in currently existing Philippine law.

Paragraph (1) provides that a citizen of one Contracting State who is a resident of the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof. The determination of whether more burdensome taxation exists is to be made by comparing the treatment of individuals who are in comparable positions. Thus, for example, a citizen of the Philippines who is a resident of the United States and who otherwise meets the requirements specified in section 911 of the Code would, under this Article, be eligible for the benefits of section 911 even though not a citizen of the United States. On the other hand, just as a United States citizen who becomes a nonresident alien at any time during a taxable year or whose spouse is a nonresident alien at any time during a taxable year cannot file a joint return for that year, a Philippine citizen would not be entitled to file a joint return with his spouse if either is a nonresident alien at any time during the taxable year and the election provided in section 6013(g) of the Code has not been made.

Paragraph (2) provides that a permanent establishment which a resident of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a resident of that other Contracting State carrying on the same activities. However, this does not obligate a Contracting State to grant to individual residents of the other Contracting State any personal allowances, reliefs, or deduction for taxation purposes on account of civil status or family responsibility which it grants its own individual residents.

Paragraph (3) prohibits one Contracting State from subjecting a corporation of such Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than those applicable to corporations of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of the first-mentioned Contracting State.

Under paragraph (4), the term "taxes" or "taxation" means, for purposes of this Article, taxes or taxation of every kind imposed at the national, state or local level, notwithstanding any other provision of the Convention. However, for other purposes of the Convention, the term "tax" means tax imposed by the United States or the Philippines to which the Convention applies. See paragraph (1)(g) of Article 2 (General Definitions).

Paragraphs (5) and (6) are exceptions to the general rules set forth in paragraphs (1), (2), and (3). Paragraph (5) provides that, with respect to the income tax imposed under Title II of the Philippine Code, nothing in paragraphs (1), (2), and (3) will prevent the Philippines from limiting to its citizens or corporations the enjoyment of tax incentives granted under the following three provisions of Philippine law: section 6 of the Investment In-

centives Act (Republic Act No. 5186); sections 5 and 7(b) of the Export Incentives Act (Republic Act No. 6135); and section 9 of the Investment Incentives Program for the Tourism Industry (Presidential Decree No. 535). However, only the incentives which were in force on and have not been modified since October 1, 1976, the date of signature of the Convention, or have been modified only in minor respects so as not to affect their general character, may be limited to Philippine citizens or corporations.

The policy of the Investment Incentives Act, as expressed in section 2 thereof, is the acceleration of the sound development of the Philippine economy in consonance with the principles and objectives of economic nationalism.

The Investment Incentives Act, the Export Incentives Act, and the Investment Incentives Program for the Tourism Industry represents a broad Philippine program to develop specific areas of the Philippine economy without relinquishing Philippine control thereover. Under that program, certain Philippine corporations can register with the Philippine Board of Investments, and become registered enterprises. To register, generally, 60 percent of a Philippine corporation's voting stock must be owned and confronted by Philippine nationals. If a registered enterprise is engaged in specified preferred economic areas of investment or becomes a pioneer enterprise, the corporation and its investors, both foreign and Philippine, are entitled to specified economic or tax incentives which are not otherwise granted by Philippine internal law. A pioneer enterprise is a registered enterprise that is engaged in the manufacture, processing, or production of goods, products, or raw material that are not being produced in the Philippines on a commercial scale or is a registered enterprise which uses a design, formula, scheme, method, process, or system of production or transformation which is new or untried in the Philippines and which involves the substantial use and processing of Philippine raw materials.

The incentives granted under the provisions referred to in paragraph (5) are limited, with one exception which relates to certain Philippine corporations, to Philippine nationals. A Philippine national is a Philippine citizen, a partnership or association wholly owned by Philippine citizens, a Philippine corporation of which at least 60 percent of the outstanding voting shares are owned and held by Philippine citizens, or trustees of certain pension trusts benefitting Philippine nationals.

The following three incentives are granted by section 6 of the Investment Incentives Act to Philippine nationals who invest in pioneer enterprises. First, Philippine nationals are allowed a deduction from their taxable income (which cannot exceed 10 percent of taxable income) for an investment of cash or property made in the form of an acquisition of shares in the original or increased capital stock of a pioneer enterprise. A deduction is allowed only if the investment is made within 7 years from the date of the corporation's registration and the shares are held for a period of not less than 3 years. In addition, Philippine nationals are granted an exemption from Philippine income tax for capital gains which are invested in new issues of capital stock of, or in the purchase of stock owned by foreigners in, pioneer enterprises. However, the investment must be made within 6 months from the date of realization of the gain and the stock must not be disposed of for 3 years. Finally, gain realized by Philippine nationals upon the disposition of stock dividends received from pioneer enterprises are exempt from tax, provided such disposition occurs within 7 years from the date of registration of the enterprise. Section 5 of the Export Incentives Act grants the same three incentives to Philippine nationals for investment in registered export producers that are pioneer enterprises. Section 9 of the Investment Incentives Program for the Tourism Industry grants only two of those incentives—the deduction for investment and the capital gains exemption—to Philippine nationals who invest in registered tourism enterprises.

Section 7(b) of the Export Incentives Act differs from the above described tax incentives in that it applies to the export producer rather than the investor therein. Under that section, a registered export producer which is a Philippine citizen or a Philippine corporation of which 60 percent of its capital is owned and controlled by Philippine citizens is entitled to a deduction from taxable income in an amount equivalent to the sum of the direct labor cost and local raw materials used in the manufacture of export products. That deduction may only be claimed during the 5-year period beginning on the date of its registration and cannot exceed 25 percent of the registered export producer's taxable income.

Other tax incentives found in the above described acts or the presidential decree or in other acts or decrees which result in more burdensome taxation for United States persons resident in the Philippines, or Philippine corporations partly or wholly owned or controlled directly or indirectly by United States residents are subject to the general rules of paragraphs (1), (2), and (3). Thus, United States citizens will be eligible for these incentives.

Paragraph (6) provides that, with respect to taxes other than the income tax imposed under Title II of the Philippine Code, nothing in the first three paragraphs will prevent the Philippines or a political subdivision or local authority thereof from limiting to Philippine citizens or corporations the enjoyment of tax incentives for the promotion of industry or business, similar to those discussed above in connection with paragraph (5). However, only the incentives which were in force on, and have not been modified since October 1, 1976, the date of signature of the Convention, or have been modified only in minor respects so as not to affect their general character, may be limited to Philippine citizens or corporations.

A final exception to the general rules of paragraphs (1), (2), and (3) relates to the taxation of income derived from the operation of ships and aircraft in international traffic. See the discussion of Article 9 (Shipping and Air Transport), supra.

ARTICLE 25. MUTUAL AGREEMENT PROCEDURE

Under paragraph (1), when a resident or citizen of one Contracting State considers that action of one or both Contracting States results or will result for him in taxation not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident or citizen. A resident or citizen of a Contracting State need not, although it is anticipated that in the normal situation he will, exhaust his other administrative or judicial remedies prior to resorting to the use of the mutual agreement procedure. If the claim is considered to have merit by the competent authority, that competent authority will endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation not in accordance with the Convention.

Paragraph (2) requires the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may agree to the same attribution of business profits to a resident of one Contracting State and its permanent establishment situated in the other Contracting State; the same allocation of income, deductions, credits, or allowances between a resident of one Contracting State and a related person and to the readjustment of taxes imposed by each Contracting State to reflect such allocation; the same determination of the source of particular items of income; and, the same characterization of particular items of income.

Under paragraph (3), in implementing the provisions of this Article, the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions.

Under paragraph (4), in cases in which the competent authorities reach an agreement, taxes will be imposed on such income and refund or credit of taxes will be allowed by the Contracting States in accordance with such agreement. In the case of the United States, where an agreement is reached between the competent authorities which requires the United States to make a refund of tax or to extend any other similar credit, such refund or credit will be allowed, notwithstanding procedural barriers otherwise existing under United States law, such as the statute of limitations. In cases where an agreement cannot be reached between the two competent authorities, the United States will not be required to provide any relief for double taxation on a unilateral basis. Paragraph (4), of course, does not authorize the imposition of additional taxes after the statute of limitations has run.

In the case of the Philippines, a refund or credit will also be allowed, but such refund or credit will be subject to Philippine procedural rules (including the statute of limitations). This permits the Philippines to disallow a claim for refund or credit on the basis of section 309 of the Philippine Code, if that claim is filed later than 2 years from the payment of the tax. However, the Philippines will issue a tax credit certificate, notwithstanding any Philippine

procedural rule, such as section 309 of the Philippine Code, if a claim is filed with the competent authority of the Philippines no later than 2 years from the close of the Philippine taxable year in which the United States tax imposed under paragraph (4) is paid. The amount of the tax credit certificate will be computed in the same manner as if an actual refund had been made. It may be used only as a credit against Philippine tax liability and will not give rise to a refund.

When the Philippine tax credit certificate is used by a taxpayer to offset its Philippine tax liability, there is an adjustment in Philippine taxes for U.S. tax credit purposes: the Philippine taxes paid by that taxpayer for the year (or years) with respect to which the certificate was issued are reduced to the extent that the credit authorized in the certificate is used to offset its Philippine taxes in another year (or years). Consequently, for U.S. tax credit purposes, there is no reduction in the taxpayer's Philippine taxes for the year (or years) with respect to which the certificate is used as a credit against its Philippine taxes.

Because books of accounts and other accounting records must be preserved, under section 337 of the Philippine Code, for a period of at least 5 years from the date of the last entry in each book, it is anticipated that the competent authority of the Philippines will have at his disposal sufficient information to come to an agreement with the competent authority of the United States so that taxation not in accordance with the provisions of the Convention will be avoided. Thus, if a claim for a tax credit certificate is filed within 5 taxable years from the close of the Philippine taxable years in issue, the competent authorities of both Contracting States will communicate or meet and, if agreement is reached, the tax credit certificate will be issued. However, if a claim is filed after the aforementioned 5-taxable year period, the competent authority of the Philippines may not have sufficient information at his disposal to come to an agreement with the competent authority of the United States if the Philippine taxpayer did not preserve its books of accounts or other accounting records for longer than the 5-year minimum period. To facilitate the agreement process between the competent authorities of the two Contracting States, paragraph (4) provides that a tax credit certificate will be issued with respect to a claim filed after the 5-taxable year period beginning with the close of the Philippine taxable year in issue only if the claim is supported by the books and records of the taxpayer.

ARTICLE 26. EXCHANGE OF INFORMATION

Paragraph (1) provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information necessary for the carrying out of the Convention and of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is in accordance with the Convention. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes. Information need be exchanged, however, only if it is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

Paragraph (2) provides that information exchanged must be treated as secret. However, such information may be disclosed to any persons or authorities concerned with or made part of the public record with respect to the assessment, collection, or enforcement of, or litigation with respect to, the taxes which are the subject of the Convention. Thus, disclosure is not prohibited as a part of a public proceeding before a court or an administrative body.

Paragraph (3) provides that no information may be exchanged which would be contrary to public policy.

Paragraph (4) provides that if information is requested by a Contracting State in accordance with Article 26, the other Contracting State will obtain the information to which the request relates from or with respect to its residents or with respect to its residents or corporations in the same manner and to the same extent as if the tax of the requesting State were the tax of the other State and were being imposed by the other State. A Contracting State may obtain information from or with respect to its residents or corporations in accordance with paragraph (4) for the sole purpose of assisting the other Contracting State in the determination of the taxes of that other State. Thus,

a Contracting State may use the mechanisms provided by its internal law to obtain information for the other Contracting State even if it has no internal tax interest in obtaining that information; its only interest being the request made under paragraph (4).

Paragraph (5) provides that depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings) may be provided by the competent authority of a Contracting State if specifically requested by the competent authority of the other Contracting State to the extent such depositions and documents can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

Paragraph (6) provides that the exchange of information may be on either a routine basis or on request with reference to particular cases, and that the competent authorities may agree on the list of information to be furnished on a routine basis.

ARTICLE 27. ASSISTANCE IN COLLECTION

Paragraph (1) provides that one Contracting State will give the other Contracting State limited assistance in collecting its taxes. Thus, each Contracting State is required to collect on behalf of the other Contracting State only those taxes imposed by such other Contracting State as will ensure that any exemption or reduced rate of tax granted under this Convention by such other Contracting State is not enjoyed by persons not entitled to such benefits.

Paragraph (2) makes clear that a Contracting State is not obligated to carry out measures at variance with the laws or the administrative practice of either Contracting State with respect to the collection of its own taxes.

ARTICLE 28. DIPLOMATIC AND CONSULAR OFFICERS

This Article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements. This is merely a special case of the general rule provided in paragraph (2) of Article 6 (General Rules of Taxation).

ARTICLE 29. ENTRY INTO FORCE

Paragraph (1) provides that the Convention is subject to ratification and provides for the exchange of instruments of ratification. The Convention will enter into force 30 days after the date of exchange of such instruments of ratification. The Convention shall first have effect as respects the rate of withholding of tax, to amounts paid on or after January 1 of the year following the date on which the Convention enters into force and, as respects other taxes, to taxable years beginning on or after January 1 of the year following the date on which the Convention enters into force. However, paragraph (2) provides an exception to those effective dates. Under paragraph (2)(b)(iii) of Article 13 (Royalties), the tax imposed by the Philippines on royalties derived by residents of the United States is limited to an amount that does not exceed the lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third State. That provision will not have effect before January 1, 1979, with respect to payments received as consideration for the use of, or the right to use, a copyright of cinematographic films or films or tapes used for radio or television broadcasting.

ARTICLE 30. TERMINATION

Article 30 provides that the Convention will continue in force indefinitely, but that it may be terminated by either Contracting State at any time after 5 years from the date it enters into force. A Contracting State seeking to terminate the Convention must give at least 6 months' prior notice through diplomatic channels. If the Convention is terminated, such termination will be effective with respect to income of calendar years or taxable years beginning (or, in the cases of taxes payable at source, payments made) on or after January 1 next following the expiration of the 6-month period. It is intended that the reference to calendar years applies only to cases where the taxable year is the calendar year.

MARCH 1, 1977.

Hon. JACOB K. JAVITS,
U.S. Senate,
Washington, D.C.

Attention: John Rosenbaum

DEAR SENATOR JAVITS: This is in reply to a letter from your office dated January 3, 1977, requesting the views of the Department of the Treasury on objections which have been raised to the provisions concerning entertainers and athletes in the proposed income tax treaties with the Republic of the Philippines and the United Kingdom. We have set forth below summaries of the relevant treaty provisions, their background and Treasury's views with respect to these provisions.

THE ENTERTAINER AND ATHLETE ARTICLES

Article 17 of the proposed treaty between the United States and the United Kingdom provides that the income derived by entertainers and athletes from their personal activities may be taxed in the contracting state in which their activities are exercised. An exception is provided where the amount of gross receipts derived by the entertainer or athlete does not exceed $15,000 United States dollars. In situations where income attributable to the activities of the entertainer is initially received by another person and the entertainer or athlete participates directly or indirectly in the profits of such other person, then such income is viewed as the income of the entertainer and taxable in the country where the activities are performed.

Article 17 of the proposed treaty with the Republic of the Philippines is substantially similar to the United Kingdom article and also allows the country of source to impose a tax. However, that tax may be imposed only to the extent that the income exceeds $100 U.S. dollars per day or exceeds in the aggregate $3,000 U.S. dollars per year.

THE OBJECTIONS RAISED

We assume that objections are being raised because these treaties place a dollar limitation on the amount of income earned by entertainers and athletes which will be exempt in the country of the source of such income. In comparison, these treaties provide more favorable treatment to income earned by others from the performance of personal services. In both treaties, income derived from the performance of personal services in a dependent capacity is exempt from tax in the country of source without any dollar limitation. Income from the performance of personal services in an independent capacity is exempt in the country of source without limitation in the case of the treaty with the United Kingdom; in the case of the treaty with the Philippines, this exemption has a dollar limitation but the dollar limitation is higher than that provided in the Philippine article on entertainers and athletes.

We also assume that, in the case of the proposed treaty of the United Kingdom, there is some concern with regard to the high rates of tax which are in effect in the United Kingdom.

THE VIEWS OF THE O.E.C.D. AND U.S. TREATY PARTNERS

It has been Treasury's experience that most countries enter into tax treaties with the view that the taxation of entertainers and athletes presents special problems and that the solution to these problems is to exclude entertainers and athletes from the personal services articles of treaties. As a result, their income is taxed in the country of source.

The Organization for Economic Cooperation and Development has taken a position on this issue in Article 17 (Artistes and Athletes) of their model income tax convention. That article excludes entertainers and athletes from the coverage of the articles on dependent and independent services and provides that they may be taxed in the country of the source of their income. The O.E.C.D. commentary explains that Article 17 makes it possible to avoid the practical difficulties which often arise in taxing entertainers and athletes performing abroad.

Thus, the current international standard is to treat entertainers and athletes much more harshly than would be done by the proposed United Kingdom and Philippine treaties.

THE VIEWS OF THE TREASURY

The Treasury is concerned about the tax treatment of entertainers and athletes in conventions. We disagree with the view of the O.E.C.D. model, which is the starting point for most treaty negotiations worldwide, and the position of many of our treaty partners, that there should be no exemption in the country of source for United States entertainers and athletes (and for foreign entertainers and athletes performing here).

The Treasury takes the position that entertainers and athletes should be treated as others performing services; i.e., they should receive a reasonable exemption from tax in the country of source. However, we recognize that entertainers and athletes often are not in the same circumstances as others performing personal services. In many situations entertainers and, to some extent, athletes receive very large sums (out of proportion to what an employee or self-employed professional would ordinarily receive) for brief visits. We also recognize that the prevailing view outside of the United States is that there be no exemption at all in the country of source. Accordingly, while we insist that entertainers and athletes receive a reasonable exemption in the country of source, we believe that it is proper to place a limit on this exemption. However, we wish to emphasize that, as in the treaties with the Philippines and the United Kingdom, this limitation will be high enough to ensure that U.S. entertainers and athletes who earn amounts comparable to ordinary standards of remuneration will be protected. It is interesting to note that because U.S. entertainers and athletes will have a limited exemption they in effect will be in a preferred position in countries with which we have a treaty vis-a-vis other foreign entertainers for whom the treaty rule is typically that of the O.E.C.D. model (taxation where the services are performed without exception). Finally, an additional element in the Treasury position is that we believe that our conventions should contain provisions to deal effectively with devices employed by foreign entertainers to avoid United States tax (these devics are explained below).

ENTERTAINER PROVISIONS IN OTHER UNITED STATES CONVENTIONS

The proposed treaties with the United Kingdom and the Philippines are not the first or the only United States conventions to provide that entertainers and athletes have a limited exemption in the country of source. For example, our treaties with Japan (entered into force on July 9, 1972), Iceland (entered into force on December 26, 1975), Trinidad and Tobago (entered into force on December 30, 1970), Romania (entered into force on January 26, 1976) and Belgium (entered into force on September 13, 1972) all contain provisions which limit the exemption of entertainers in the country of source. The limitations in these treaties with respect to entertainers and athletes apply either to dependent or independent services or to both.

The draft United States Model Income Tax Convention, which was published May 18, 1976, also adopts the position of limited exemption in the country of source for entertainers and athletes. In fact, that Model contains, in Article 17 (Artistes and Athletes) provisions which are identical to those in the proposed treaty with the United Kingdom. The United States Model, which is similar in many other respects to the O.E.C.D. model, is our starting point in treaty negotiations with other countries.

FOREIGN ENTERTAINERS AVOIDING U.S. TAX

It is stated above that Treasury believes that our conventions should contain provisions to deal effectively with devices employed by foreign entertainers to avoid United States tax. This statement requires some explanation.

It has been the experience of the United States that some foreign entertainers and athletes employ contrived business arrangements in the context of tax treaties to avoid United States tax on income earned for their performances here. In fact, the tax treaty currently in effect between the United States and the United Kingdom has been the subject of such avoidance schemes. That treaty provides, in Article XI(1), that an individual who is a resident of the United Kingdom shall be exempt from tax in the United States on compensation for personal services performed in the United States if he is present here for no more than 183 days in the taxable year and performs his services on behalf

of a person resident in the United Kingdom (i.e., performs these services in connection with an employment relationship).

One example of an avoidance technique attempted under this treaty provision is where an entertainer organizes a corporation in the United Kingdom and becomes its sole shareholder and "employee". A contract is entered into between the corporation and the "employee" to give the latter complete control over the details of his work. The payment made by the U.S. promoter for a performance by the entertainer in the United States is characterized by the entertainer, in part, as compensation for his services. The remainder is characterized as a fee to the corporation in consideration for the loan of the employee-entertainer to the U.S. or other person promoting the entertainment event. As the sole shareholder of the corporation receiving the compensation for the entertainer's performance, the entertainer subsequently receives the so-called loan-out fee as a dividend.

The purpose of such an arrangement is to obtain the exemption from tax at source provided by Article XI(1) to an employee of a corporation. Additionally, the fee paid to the United Kingdom corporation is not taxable in the United States if the foreign corporation does not have a permanent establishment in the United States. In Revenue Ruling 74–330, 1974–2 C.B. 278, the Internal Revenue Service took the position that under circumstances such as those explained above where, among other things, the entertainer retains control over the details of his work, an employer-employee relationship does not exist. Consequently, none of the income attributable to the performance of the entertainer's services qualifies for treaty exemption.

There also have been more complicated schemes under the current United States-United Kingdom Treaty such as double loan-out arrangements involving corporations organized in the Channel Islands of the United Kingdom. These arrangements are analyzed in Revenue Ruling 74–331, found at 1974–2 C.B. 281. It is our understanding that the Internal Revenue Service has docketed and settled cases involving facts which parallel those found in Revenue Rulings 74–330 and 74–331.

SOLUTION TO THE AVOIDANCE PROBLEM

As a result of experiences such as those just mentioned, the United States and the O.E.C.D. have both taken the position that where income in respect of the performance of an entertainer or athlete is not paid to the entertainer or athlete but diverted to another person, such as a so-called artiste company, such income should be taxable in the country of source where, for instance, the entertainer has control over or rights to the income thus diverted. This position is reflected in paragraph 2 of article 17 in the U.S. model, the O.E.C.D. Model, and the proposed treaties with the United Kingdom and the Philippines. It is hoped that this provision will prevent future avoidance of United States tax by foreign entertainers. It should be noted that a more general provision with the same effect is contained in the current treaty with Iceland. See Article 20 (Amounts Received for Furnishing Personal Services) of the Iceland treaty.

TAX RATES IN THE UNITED KINGDOM

It was mentioned above that United States entertainers and athletes may be concerned that article 17 of the proposed convention with the United Kingdom will subject them to very high rates of tax in the United Kingdom on the income they earn there. It is well known that rates of tax in the United Kingdom go as high as 83 percent in the case of personal services income. However, U.S. entertainers and athletes may not be aware that under United Kingdom law there is relief (i.e., a deduction) available which substantially reduces the rate of United Kingdom tax. To be specific, United Kingdom law provides that if individuals who are not British domiciliaries work for companies which are not United Kingdom residents, their earnings constitute "foreign emoluments." In the case of those foreign emoluments, a deduction is given of 50 percent of the emoluments. In other words, the maximum marginal rate of tax on the personal services income of a U.S. entertainer or athlete working in the United Kingdom as an employee of a U.S. corporation (not managed and controlled in the United Kingdom) is approximately 42 percent. However, if a U.S. entertainer or athlete becomes domiciled in the United Kingdom or is a resident in the United Kingdom for nine out of ten years of assessment, then

the deduction for foreign emoluments is eliminated and reduced to 25 percent, respectively.

NO DOUBLE TAXATION

We wish to point out that U.S. entertainers and athletes are certainly protected against double taxation under the proposed treaties with the Philippines and the United Kingdom. It is important to understand that permiting the source country to impose a tax does not constitute double taxation. Rather, the United States tax is reduced dollar for dollar by the tax paid to the country of source through the foreign tax credit.

CONCLUSION

In conclusion, it is the view of the Treasury that the articles concerning entertainers and athletes in the proposed treaties with the United Kingdom and the Republic of the Philippines are fair and reasonable. They provide an exemption for the income of entertainers, up to certain amounts, and protect the entertainers from double taxation. While the exemption is limited, the limit is high enough to cover amounts comparable to ordinary standards of remuneration. These articles (and the U.S. model) represent a viable response to demands of other countries that entertainers and athletes receive no exemption at all in the country of source. In addition, these provisions justifiably reflect the fact that some foreign entertainers and athletes have, in the past, employed contrived tax avoidance arrangements directed at the U.S. income tax.

If I can be of any further assistance to you on this matter, please let me know.

Sincerely yours,

LAURENCE N. WOODWORTH,
Assistant Secretary for Tax Policy, Department of the Treasury.

THE LIBRARY OF CONGRESS,
CONGRESSIONAL RESEARCH SERVICE,
Washington, D.C., June 6, 1977.

From: Harry G. Gourevitch, Senior Specialist in Taxation and Fiscal Policy.
To: Senate Foreign Relations Committee.
Attention: Michael Glennon.
Subject: The U.S.-U.K. Income Tax Treaty: Article 9, Para. 4, on State use of the Unitary Apportionment Method.

ARTICLE 9, PARA. 4

Article 9, para. 4, of the treaty would prohibit a state of the U.S., in determining the State income tax liability of an enterprise doing business within the State, from taking into account under the unitary apportionment method the income of a related enterprise which is a resident of the U.K. (or of an enterprise which is a resident of any third country and which is related to the U.K. enterprise), unless the U.K. enterprise is owned by the U.S. enterprise.[1]

This prohibition is designed to bar a State's use of the unitary apportionment method to allocate income of a U.K. parent corporation to its U.S. subsidiary. It would also prevent a State's use of the unitary apportionment method to allocate income of any third country (e.g. German and Swiss) subsidiaries of the U.K. parent to the U.S. subsidiary. The provision would not, however, bar the use of the unitary apportionment method to allocate income of a U.K. related corporation which is a subsidiary of the U.S. corporation.

THE UNITARY APPORTIONMENT METHOD

Under the unitary apportionment method (also known as the unitary business method) certain states (i.e. Alaska, California, Oregon, and possibly others)

[1] Para 4 contains certain additional technical requirements for the prohibition to apply: the U.K. enterprise may not be a controlled foreign corporation within the meaning of section 957 of the Internal Revenue Code; it may not be organized in the U.S. or any third country; it may not be controlled by any corporation which is a resident of any third country.

apply a three factor apportionment formula (sales, payroll, property) not only to the income of a corporation doing business within the State, but also to the income of related foreign corporations) where activities of the related foreign corporations are dependent upon or contribute to the business of the corporation within the State. This method in effect requires the U.S. corporation to file a consolidated state tax return which includes the income of its foreign affiliates regardless of whether or not they are engaged in business in the State. The three factor formula basically works as follows: if a corporation doing business in a state has one-half the sales, one fourth the property and three fourths the payroll of a related group of corporations operating worldwide, and if the group's remaining sales, payroll and property are attributable to its foreign affiliates not engaged in business in the State, the State will tax the corporation operating in the state on one-half the group's worldwide income.

It should be noted that most States use the three factor formula to determine the amount of income earned by a corporation within the State, and that these States generally include the income of foreign branches of domestic corporations in the income subject to the apportionment formula. But only California, Oregon, Alaska and possibly one or two other States apply the apportionment formula to the income of related foreign corporations not engaged in business within the State.

THE ISSUE

The States that would be affected contend the prohibition on their use of the unitary apportionment method would make them lose substantial amounts of tax revenues. These States are urging or will urge the Senate to vote for a reservation to article 9, para. 4. Multinational corporations generally do not like the unitary apportionment method. They contend that under this method States are taxing the foreign source income of foreign corporations not doing business in the State. The treaty would benefit directly only U.K. headquartered multinationals, like British Petroleum. However, as discussed later, U.S. headquartered multinationals with operations in the U.K. may also be taking an interest in the fate of article 9, para. 4, even though they would not be direct beneficiaries of the provision.

In deciding whether or not to vote for a reservation to article 9, para. 4, a judgment may have to be made as to whether the U.K. will reject the treaty if this provision is deleted.

THE POSITION OF THE STATES

1. The unitary apportionment method accurately reflects the fact that all parts of a business enterprise, including its foreign affiliates, contribute to its profitability. The method does not result in States taxing foreign source income of related foreign corporations, but merely in the apportionment of the worldwide income of a unitary business conducted through a group of separate corporations in accordance with economic reality so that all elements of the business are treated as generating income in proportion to the three factors (sales, payroll, property).

2. If States are not allowed to use this method to determine income subject to state income tax, multinational corporations doing business within the State will be able to avoid State taxes by using related foreign corporations to play shell games with their income. For example, the State of Alaska has contended that article 9, para. 4 of the treaty would result in an annual revenue loss of up to $50 million annually on British Petroleum's operations on the North Slope alone. California also estimates large revenue losses if article 9, para. 4 enters into force.

3. Professor Ferdinand P. Schoettle of the University of Minnesota Law School believes that a Federal policy on State taxation of interstate and international business is desirable, but he does not like to see the policy formulated as part of a treaty.[2]

POSITION OF THE MULTINATIONALS (AND THE UNITED KINGDOM)

1. The unitary apportionment method results in a State taxing the foreign source income of related foreign corporations not doing business within the State. The three-factor formula need not have this result if the same number

[2] Schoettle, Ferdinand P., "States Have Major Stake in U.K. Treaty", Tax notes, vol. V, No. 14, p. 3 (Apr. 4, 1977).

of sales, the same size payroll and the same amount of property produce in the related foreign corporations the same level of income as in the corporation operating within the State. However, the formula does tax foreign source income of related foreign corporations because in many foreign countries wage rates and property values are lower than in the U.S., resulting in higher profit margins on operations in those countries and the apportionment of too much income to operations in the U.S.

2. The method is applied arbitrarily by the States to combine into a single business unit foreign corporations related to the corporation operating in the State. Generally a State applying the unitary apportionment method assumes that the worldwide operations of a multinational enterprise are linked to the operations of the local affiliate. This assumption may be unjustified as in particular cases the activities of some members of an affiliated group may be totally unrelated or only tenuously related to the activities of other members.

3. The method imposes unreasonable administrative burdens on multinational corporations, as a multinational corporation may be required to submit to State tax authorities figures on income, sales, payroll and property of foreign affiliates. This may be very expensive if the foreign books are kept in a foreign language and in a foreign currency, and if they are based on different accounting rules.

TREASURY'S POSITION

Former Secretary of the Treasury William Simon is on record as stating that he believes the article 9, para. 4, prohibition is appropriate for inclusion in our income tax treaties. Presumably this is also the position of the present administration.

In answer to the argument that without the ability to use the unitary apportionment method a state would be unable to deal with attempts by multinational corporations to play shell games with their income, the Treasury in its technical memorandum has stated that a State may still reallocate income of a U.K. parent corporation to a subsidiary operating in the State under the arm's length principles contained in the other paragraphs of Article 9.[3]

Paragraph 1 of article 9 confirms the authority of the U.S. to reallocate income between related entities under the arm's length standards of section 482 of the Internal Revenue Code. Under Section 482, the Commissioner of Internal Revenue has wide discretion to reallocate income (and related items) between related entities in order to clearly reflect income or to prevent the avoidance of Federal income tax.

The Treasury's position, as expressed in article 9, is that a state may not reallocate income of a U.K. parent to its U.S. subsidiary under the unitary apportionment method, but that it may do so under the arm's length standards of section 482 of the Internal Revenue Code. States, however, contend that the section 482 arm's length standards are much more complicated to apply than the unitary apportionment method, and that states lack sufficient expertise and manpower for the time consuming and complex factual investigations that would be required. The States also contend that they cannot expect real help from the Internal Revenue Service as the Service generally will not participate in joint audits with a state.

OTHER INTERESTED GROUPS

As noted earlier, U.S. multinational corporations with operations in the U.K. may also take an interest in the fate of article 9, para. 4, even though they would not benefit directly from its prohibition on state use of the unitary apportionment method. United States multinationals stand to receive substantial refunds of United Kingdom tax under article 10 of the treaty, relating to Dividends. They are concerned that if the Senate votes in favor of a reservation to article 9, para. 4, they will lose these refunds as the U.K. may reject the treaty if article 9, para. 4, is deleted. While it is unclear whether the U.K. would still accept the treaty with a U.S. reservation to article 9, para. 4, there is concern that the U.K. may view the benefits granted under article 9, para. 4, to U.K. investors in the U.S. as the quid pro quo for the benefits granted under Article 10 to U.S. investors in the U.K.

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[3] "The taxing jurisdiction may, however, attribute income to the enterprise under the arm's length principles contained in the other paragraphs of this Article." "Technical Explanation of the U.S. and U.K. Income Tax Treaty", p. 20.

TECHNICAL ISSUE

The United States Treasury in its technical memorandum has stated that under article 9, para. 1, a state would still be free to reallocate income under section 482 arm's length standards. However, the treaty language is unclear on this point. Article 9, para. 1, only authorizes an arm's length type of reallocation by a Contracting State, not also by a political subdivision of a contracting State. Yet para. 4 of the same article, which bars states from reallocating income under the unitary apportionment method, refers explicitly to a contracting State or a "political subdivision or local authority" of such state. Thus, if Para. 1 had intended to confer section 482 rights on states of the U.S., it should have included a specific reference to a "political subdivision" of a contracting State. This omission was probably inadvertent as concerns the U.S. negotiators, and the U.S. Treasury intends the provision to be read as applying also to States. However, it is not clear that the U.K. would give the paragraph the same reading. It may be useful during the hearings to clarify this point, either by eliciting testimony from Treasury witnesses as to whether the U.K. concurs in the Treasury's interpretation or by appropriate language in the committee report.

TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE REPUBLIC OF KOREA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND THE ENCOURAGEMENT OF INTERNATIONAL TRADE AND INVESTMENT, SIGNED AT SEOUL ON JUNE 4, 1976

[Supplied by Department of the Treasury]

ARTICLE 1. TAXES COVERED

Paragraph (1) designates the taxes of the contracting States which are the subject of the convention. In the case of the United States, the subject taxes are the Federal income taxes imposed by the Internal Revenue Code ("Code") (referred to as "United States tax"). However, in certain situations described in paragraph (8) of article 4 (General Rules of Taxation), the United States reserves its right to impose taxes under sections 531 (accumulated earnings tax) and 541 (personal holding company tax), except as provided in such paragraph (8).

In the case of Korea, paragraph (1) provides that the subject taxes are the income tax and the corporation tax (referred to as "the Korean tax"). In an exchange of notes, Korea has agreed that the term "Korean tax" also includes the Korean Defense tax assessed on the taxes referred to in paragraph (1).

Pursuant to paragraph (2), the convention will also apply to taxes substantially similar to those covered by paragraph (1) which are imposed in addition to, or in place of, existing taxes, after June 4, 1976 (the date of signature of the convention).

Under paragraph (3), for the purpose of article 7 (Nondiscrimination), the convention will apply to taxes of every kind imposed at the national, state, or local level; and for purposes of article 28 (Exchange of Information), the convention will apply to taxes of every kind imposed at the national level.

ARTICLE 2. GENERAL DEFINITIONS

Paragraph (1) sets out definitions of certain basic terms used in the convention. A number of important terms, however, are defined elsewhere in the convention.

The term "United States" means the United States of America. When used in a geographical sense, the term means the States of the United States and the District of Columbia. Thus, this convention does not apply to possessions of the United States or the Commonwealth of Puerto Rico. The term "Korea" means the Republic of Korea.

When used in a geographical sense, the term "Korea"" means all territory in which the laws relating to Korean tax are in force, and the terms "United States" and "Korea" also include their respective territorial seas and, in general accord with the principles of section 638 of the Code, their continental shelves.

The term "Contracting State" means the United States or Korea as the context requires.

The term "person" includes an individual, a partnership, a corporation, an estate, a trust or any body of persons.

The term "United States corporation" or "corporation of the United States" is defined as a corporation which is created or organized under the laws of the United States, and state thereof, or the District of Columbia, or any unincorporated entity treated as a United States corporation for United States tax purposes. A "Korean corporation" or "corporation of Korea" is defined as a corporation (other than a United States corporation) which has its head or main office in Korea, or any entity treated as a Korean corporation for Korean tax purposes.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to Korea, it means the Minister of Finance or his delegate.

The term "State" means the United States, Korea or any other National State.

The term "citizen," in the case of the United States, is defined as a citizen of the United States, and in the case of Korea, the term is defined as a national of Korea.

Paragraph (2) provides that any term used in the convention which is not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of the contracting State whose tax is being determined. However, where a term has a different meaning under the laws of Korea and the United States or where the meaning under the laws of one of the contracting States is not readily determinable, the competent authorities may for purposes of the convention establish a common meaning in order to prevent double taxation or to further any other purpose of the convention.

ARTICLE 3. FISCAL DOMICILE

This article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the convention. Residence is important because, in general, only a resident of one of the contracting States may qualify for the benefits of the convention.

In paragraph (1), the term "resident of Korea" is defined as a Korean corporation (as defined in Article 2 (General Definitions)) and any person (except a corporation or any entity treated under Korean law as a corporation) resident in Korea for purposes of its tax. Similarly, "resident of the United States" means a United States corporation (as defined in article 2 (General Definitions)) and any person (except a corporation or any unincorporated entity treated as a corporation for United States tax purposes) resident in the United States for purposes of its tax. Thus, a resident of the United States includes a resident alien individual and a resident citizen but under no circumstances a foreign corporation. A citizen of the United States or Korea is not automatically a resident of the United States or Korea for purposes of this convention.

The convention provides that a person acting as a partner or fiduciary is considered a resident of a contracting State only to the extent that the income derived by such person is subject to tax in such contracting State as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the convention, income received by a partnership, estate, or trust will not be treated for purposes of the convention as income received by a resident of the United States unless such income is subject to tax in the United States as the income of a resident. Thus, the treatment of income received by a partnership will be determined by the residence and taxation of its partners for United States tax purposes with respect to that income. To the extent the partners are subject to United States tax as residents of the United States, the partnership will be treated as a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

Paragraph (1) also provides that in determining the residence of a partnership which makes a payment, that partnership shall be considered a resident of the State under the laws of which it was created or organized. This paragraph is to be used in the determination of the source of interest. Thus, if a partnership organized in the United States pays interest to a resident of Korea, the source of the interest would be the United States even if none of the partners are residents of the United States.

Under paragraph (2), an individual who is a resident of both Contracting States under paragraph (1) will, for purposes of the Convention, be deemed to be a resident of the Contracting State in which he has his permanent home (where an individual dwells with his family), his center of vital interests (closest economic and personal relations), a habitual abode, or his citizenship, in the order listed. If the issue is not settled by these tests, the competent authorities will decide by mutual agreement the one Contracting State of which he will be considered to be a resident.

Since the definitions of residence in this article apply for purposes of the entire Convention, an individual who is deemed to be a resident of one Contracting State and not a resident of the other Contracting State by reason of paragraph (2) will be deemed to be a resident only of the first-mentioned Contracting State for all purposes of the Convention, including Article 4 (General Rules of Taxation). For example, if an individual is determined to be a resident of Korea under paragraph (2) and is also considered to be a resident of the United States under the laws of the United States, such individual would continue to receive the exemptions and special benefits granted by the Convention to residents of Korea, unless the individual is a citizen of the United States (see the saving clause of paragraph (4) of Article 4 (General Rules of Taxation)).

ARTICLE 4. GENERAL RULES OF TAXATION

Under paragraph (1), a resident of one Contracting State may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income, subject to any limitations set forth in the Convention. For this purpose, the source rules contained in Article 6 (Source of Income) are to be applied. However, if the resident is a citizen of the other Contracting State, that other Contracting State may tax the resident without regard to this paragraph because of the saving clause of paragraph (4) of this article.

Paragraph (2) contains the customary rule that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of a tax imposed by it, or by any other agreement between the Contracting States. This rule reflects the principle that a convention should not increase the tax burden on residents of the Contracting States.

Paragraph (3) provides that the provisions of the Convention shall not affect Korean law so as to deny benefits accorded residents of the United States under the provision of the Korean Foreign Capital Inducement Law No. 2598 of March 12, 1973 as amended or any similar law to encourage investment in Korea. This paragraph applies only with respect to Korean law, and has no impact on United States tax on the Korean source income which may benefit from such provisions.

Paragraph (4) contains the traditional saving clause under which the United States reserves the right to tax its citizens and residents (as determined under Article 3 (Fiscal Domicile)) as if the Convention had not come into effect. However, under paargraph (5), the saving clause does not apply in several cases in which its application would contravene policies reflected in the Convention. Thus, the saving clause does not affect the provisions with respect to relief from double taxation, nondiscrimination, social security payments, or the mutual agreement procedure. Moreover, the saving clause does not affect the benefits of the Convention to teachers, students and trainees, and individuals performing governmental functions, who are neither citizens of, nor have immigrant status in, the Contracting State imposing the tax. In the case of the United States, "immigrant status" means the individual has been admitted to the United States for permanent residence. The saving clause is reciprocal.

Paragraph (6) authorizes the competent authorities of the Contracting States to prescribe regulations necessary to carry out the provisions of the Convention. On the United States side, this authority is also provided by section 7805 of the Code.

Paragraph (7) allows, for purposes of United States tax, in the case of a resident of Korea who is not a resident of the United States, a deduction for personal exemptions (subject to the conditions prescribed in sections 151 through 154 of the Code as in effect on June 4, 1976) for the spouse of the taxpayer and for each child of the taxpayer present in the United States and residing with him in the United States at any time during the taxable year. These additional deductions shall not exceed that proportion of the taxpayer's

entire income from all sources, for any taxable year, which is from sources within the United States and which is treated as effectively connected with the conduct of a trade or business within the United States within the meaning of section 864(c). These additional deductions are to continue as long as section 873 of the United States Internal Revenue Code provides only one personal exemption for a taxpayer who is a resident of Korea and not a resident of the United States.

Paragraph (8) reserves the right of the United States to impose its personal holding company tax (section 541 of the Code) and its accumulated earnings tax (section 531 of the Code) notwithstanding any provision of the Convention. However, paragraph (8) also provides that a Korean corporation will be exempt from the personal holding company tax in any taxable year if all of its stock is owned, directly or indirectly, by one or more individuals who are residents of Korea (and not citizens of the United States) for that entire year. In addition, a Korean corporation will be exempt from the accumulated earnings tax in any taxable year unless it is engaged in trade or business in the United States through a permanent establismment at any time during such year. Even if a Korean corporation is engaged in trade or business in the United States through a permanent establishment at any time during the taxable year it may be subjected to the accumulated earnings tax only with respect to any income derived from sources within the United States. See Regulation section 1.532–1(c).

ARTICLE 5. RELIEF FROM DOUBLE TAXATION

Under paragraph (1), the United States agrees to allow a United States citizen or resident as a credit against the United States tax the appropriate amount of Korean tax in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the principles of paragraph (1)). In addition, in the case of a United States corporation owning at least ten percent of the voting power (i.e., voting stock) of a Korean corporation from which it receives dividends in any taxable year, the United States will allow credit for the appropriate amount of Korean tax paid by the Korean corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid to Korea, but the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within Korea or on income from sources outside of the United States) provided by United States law for the taxable year. This provision does not require the United States to maintain a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect. For the purpose of applying the United States credit in relation to taxes paid to Korea, the rules set forth in Article 6 (Source of Income) will be applied to determine the source of income.

Paragraph (2) contains a reciprocal provision under which, in accordance with the provisions and subject to the limitations of Korean law (as it may be amended without changing the general principles of the treaty article), Korea will allow to its citizens and residents a credit against Korean tax for the appropriate amount of income taxes paid to the United States. Furthermore, in the case of a Korean corporation owning at least ten percent of the voting power of a United States corporation from which it receives dividends in a taxable year, Korea shall allow a credit for the appropriate amount of taxes paid to the United States by the United States corporation paying the dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based on the amount of tax paid to the United States, but the credit may not exceed that portion of Korean tax which such citizen's or resident's net income from sources within the United States bears to his entire net income for the same taxable year. For the purpose of applying the Korean credit in relation to taxes paid to the United States, the rules set forth in Article 6 (Sources of Income) shall be applied to determine the source of the income.

ARTICLE 6. SOURCE OF INCOME

This article contains the source rules which are to be used in applying the provisions of the Convention, such as Article 5 (Relief from Double Taxation). Under Article 4 (General Rules of Taxation), one Contracting State may tax

a resident of the other Contracting State only on income from sources within the first-mentioned Contracting State (provided the resident is not a citizen of the first-mentioned Contracting State).

Paragraph (1) provides that dividends will be treated as income from sources within a Contracting State only if paid by a corporation of that Contracting State.

Under paragraph (2), with two exceptions, interest will be treated as income from sources within a Contracting State only if paid by that Contracting State, a political subdivision or a local authority thereof, or by a resident of that Contracting State. Under the first exception, if the person paying the interest (whether or not such person is a resident of a Contracting State) has a permanent etablishmemt in a Contracting State in connection with which the indebtedness on which the interest is paid was incurred and such interest is borne by the permanent establishment, the interest will be deemed from sources within the Contracting State in which the permanent establishment is situated. For example, if a resident of France has a permanent establishment in Korea which borrows money from a resident of the United States and bears the interest, the interest will be deemed to be from Korean sources. Thus, if the limitation in paragraph (2) of Article 13 (Interest) is applicable, this interest will be taxed in Korea at the reduced rate. As provided in paragraph (8) of Article 9 (Permanent Establishment), the principles of Article 9 will be applied to determine whether the resident of France has a permanent establishment in Korea.

Under the second exception, paragraph (2) also provides that if the person paying the interest is a resident of a Contracting State and has a permanent establishment in a State other than a Contracting State in connection with which in the indebtedness on which the interest is paid was incurred and such interest is paid to a resident of the other Contracting State, and such interest is borne by the permanent establishment, the interest will be deemed from sources within the State in which the permanent establishment is situated. This interest will be exempt from tax in the Contracting State where the payor is a resident if paid to a resident of the other Contracting State because, under Article 4 (General Rules of Taxation), a resident of one Contratcing State, not a citizen of the other Contracting State, may be taxed by that other Contracting State only on income from sources within that other Contracting State.

Paragraph (3) provides that royalties described in paragraph (4) of Article 14 (Royalties) for the use of, or the right to use, property or rights other than as provided in paragraph (5) with respect to ships or aircraft, described in such paragraph will be treated as income from sources within a Contracting State only to the extent that such royalties are for the use of, or the right to use, such property or rights within that Contracting State.

Paragraph (4) provides that income from real property and royalties from the operation of mines, quarries, or other natural resources (including gains derived from the sale of such property or the right giving rise to such royalties) will be treated as income from sources within a Contracting State only if such property is situated in that Contracting State.

Paragraph (5) provides that income from the rental of tangible personal (movable) property will be treated as income from sources within a Contracting State only if such property is situated in that Contracting State. Income from the rental of ships or aircraft derived by a person not engaged in the operation of ships or aircraft in international traffic shall be treated as income from sources within a Contracting State only if the lessee is a resident of that Contracting State.

Under paragraph (6), income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, or for furnishing the personal services of another person and income received by a corporation for furnishing the personal services of its employees or others, will be treated as income from sources within a Contracting State only to the extent that such services are performed in that Contracting State. Income from personal services performed aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be treated as income from sources within that Contracting State if rendered by a member of the regular complement of the ship or aircraft. For purposes of this paragraph, income from labor or personal services includes pensions (as defined in

paragraph (3) of Article 23 (Private Pensions and Annuities)) paid in respect of such services. However, remuneration described in Article 22 (Governmental Functions) and payments described in Article 24 (Social Security Payments) will be treated as income from sources within the Contracting State only if paid by or from the public funds of that Contracting State or local authority thereof.

Paragraph (7) provides that income from the purchase and sale of intangible or tangible personal (including movable) property (other than gains defined as royalties by paragraph (4)(b) of Article 14 (Royalties)) will be treated as income from sources within a Contracting State only if such property is sold in that Contracting State.

Paragraph (8) contains a general qualification to the preceding source rules. It provides that industrial or commercial profits attributable to a permanent establishment which the recipient, a resident of one Contracting State, has in the other Contracting State will be treated as income from sources within that other Contracting State. Industrial or commercial profits attributable to such permanent establishment may include any item of income described in paragraphs (1) through (6) if the item of income is "effectively connected" with the permanent establishment. See the discussion of paragraph (6)(b) of Article 8 (Business Profits) for a discussion of the effectively connected concept.

Under paragraph (9) the source of any item of income to which paragraphs (1) through (8) are not applicable will be determined by each Contracting State in accordance with its own law. However, if the source of any item of income under the laws of one Contracting State is different from its source under the laws of the other Contracting State or if its source is not readily determinable under the laws of one of the Contracting States, the competent authorities of the Contracting States may, in order to prevent double taxation or further any other purpose of the Convention, establish a common source of the item of income for purposes of the Convention.

Several of the source rules set out in this article differ to some degree from those existing in the Code. Since Article 4 (General Rules of Taxation) provides that the Convention will not increase a person's United States tax, a taxpayer is not required to apply the Convention rules in calculating his United States tax liability.

ARTICLE 7. NONDISCRIMINATION

Paragraph (1) provides that a citizen of one Contracting State who is a resident of the other Contracting State will not be subjected in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof. The determination whether there is more burdensome taxation is to be made by comparing the treatment of individuals who are in comparable positions. Thus, for example, a citizen of Korea who is a resident of the United States and who otherwise meets the requirements specified in section 911 of the Code would under this article be eligible for the benefits of section 911 even though not a citizen of the United States. On the other hand, just as a United States citizen who becomes a nonresident alien at any time during a taxable year or whose spouse is a nonresident alien at any time during a taxable year cannot file a joint return for that year, a Korean citizen would not be entitled to file a joint return with his spouse if either is a nonresident alien at any time during the taxable year.

Paragraph (2) provides that a permanent establishment which a resident of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a resident of that other Contracting State carrying on the same activities. However, this does not obligate a Contracting State to grant to individual residents of the other Contracting State any personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibilities which it grants to its own individual residents.

Paragraph (3) prohibits one Contracting State from subjecting a corporation of such Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than those applicable to corporations of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of the first-mentioned Contracting State.

Under Paragraph (3) of Article 1 (Taxes Covered), the provisions of this article extend to taxes of every kind imposed at the National, state or local level.

ARTICLE 8. BUSINESS PROFITS

Paragraph (1) sets forth the general rule that industrial or commercial profits of a resident of one Contracting State are exempt from tax by the other Contracting State unless the resident is engaged in industrial or commercial activity in that other Contracting State through a permanent establishment situated therein. Where the resident is so engaged, only the industrial or commercial profits attributable to the permanent establishment can be taxed by that other Contracting State, unless the resident is a citizen of the other Contracting State. (See the saving clause in paragraph (4) of Article 4 (General Rules of Taxation).) Under paragraph (8) of Article 6 (Source of Income), industrial or commercial profits whether from sources within or without a Contracting State attributable to a permanent establishment which a resident of one Contracting State has in the other Contracting State will be considered to be from sources within that other Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code attributable to a permanent establishment situated in the United States will be subject to tax by the United States.

In determining the proper attribution of industrial or commercial profits under the Convention, paragraph (2) provides that both Contracting States will attribute to the permanent establishment such profits which would be attributable to it if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident of which it is a permanent establishment. Under paragraph (3), expenses which are reasonably connected with profits attributable to the permanent establishment, including executive and general administrative expenses, whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere, will be allowed as deductions in determining the industrial or commercial profits of the permanent establishment. However, in determining the amount of the deduction under paragraph (3) for expenses incurred by the head office, the deduction generally will be limited to the expense incurred without including a profit element for the head office.

Paragraph (4) provides that no profits shall be attributed to a permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment, or by the resident of which it is a permanent establishment, for the account of such resident. Paragraph (2) of the article does not override paragraph (4). Thus, where a permanent establishment purchases goods for its head office, the industrial or commercial profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a notional figure for profits from purchasing.

Under paragraph (5), the term "industrial or commercial activity" includes the conduct of manufacturing, mercantile, insurance, banking, financing, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, and the rental of tangible personal property (including ships or aircraft when the rental is not covered by Article 10). The term does not include the performance of personal services by an individual either as an employee or in an independent capacity.

Paragraph (6)(a) defines the term "industrial or commercial profits" to include income derived from industrial or commercial activity, and income derived from real property and natural resources and dividends, interest, royalties (as defined in paragraph (4) of Article 14 (Royalties)), and capital gains but only if the property or rights giving rise to such income, dividends, interest, royalties, or capital gains is effectively connected with a permanent establishment which the recipient, being a resident of one Contracting State, has in the other Contracting State, whether or not such income is derived from industrial or commercial activity. See paragraph (3) of Article 12 (Dividends), paragraph (4) of Article 13 (Interest), paragraph (3) of Article 14 (Royalties), and paragraph (1)(b) of Article 16 (Capital Gains).

Paragraph (6)(b) contains crieteria for determining whether property or rights are effectively connected with a permanent establishment. Factors to be taken into account include whether the rights or property are used in or held

for use in carrying on industrial or commercial activity through a permanent establishment and whether the activities carried on through such permanent establishment were a material factor in the realization of the income derived from such property or rights. For this purpose, due regard shall be given to whether or not such property or rights or such income were accounted for through such permanent establishment. The effectively connected test in this paragraph is substantially similar to the effectively connected test in section 864(c) of the Code.

Under paragraph (7), where industrial or commercial profits include items which are dealt with separately in other articles of the Convention, the provisions of those articles will, except as otherwise provided therein, supersede the provisions of this article. Thus, for example, taxation of interest income will be controlled by Article 13 (Interest) and not by this article unless, as provided by paragraph (4) thereof, the interest is effectively connected with a permanent establishment.

ARTICLE 9. PERMANENT ESTABLISHMENT

This article defines the term "permanent establishment." The existence of a permanent establishment is relevant under Article 8 (Business Profits) to the taxation of industrial or commercial profits and in determining the applicability of other provisions of the Convention.

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which industrial or commercial activity is carried on. Illustrations in paragraph (2) of a fixed place of business include a branch; an office; a factory; a workshop; a warehouse; a store or other sales outlet; a mine, quarry or other place of extraction of natural resources; and a building site or construction or installation project which exists for more than six months. As a general rule, any fixed facility or premises through which a resident conducts industrial or commercial activity for an indefinite or substantial period of time will be treated as a fixed place of business unless it is used only for one or more of the activities described in paragraph (3).

Under the construction or installation project rule the six month period begins only when work physically commences in the other Contracting State. A series of contracts or projects which are inter-dependent both commercially and geographically is to be treated as a single project for the purpose of applying the six month test.

Paragraph (3) specifically provides that a permanent establishment does not include a fixed place of business used only for one or more of the following:

"(a) The use of facilities for the purpose of storage, display, or delivery of goods or merchandise belonging to the resident;

"(b) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of storage, display, or delivery;

"(c) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of processing by another person;

"(d) The maintenance of a fixed place of business for the purpose of purchasing goods or merchandise, or for collecting information, for the resident;

"(e) The maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the resident; or

"(f) The maintenance of a building site or construction or installation project which does not exist for more than 6 months."

As noted, these exceptions are cumulative and a fixed place of business used only for one or more of these purposes will not be considered a permanent establishment under the Convention.

Paragraph (4) provides that even if a resident of one of the Contracting States does not have a permanent establishment in the other Contracting State, under paragraphs (1) through (3) of this article, he shall nevertheless be deemed to have a permanent establishment in the other Contracting State if he engages in trade or business in that other Contracting State through an agent who has authority to conclude contracts in the name of that resident and regularly exercises that authority in that other Contracting State, unless the exercise of the authority is limited to the purchase of goods or merchandise for the account of the resident, or who maintains in that other Contracting State a stock of goods or merchandise belonging to that resident from which he regularly fills orders or makes deliveries.

Under paragraph (5), notwithstanding subparagraphs (a), (c) and (d) of paragraph (3), if a resident of one of the Contracting States has a fixed place of business in the other Contracting State and goods or merchandise are either: (1) subjected to processing in that other Contracting State by another person (whether or not purchased in that other Contracting State), or (2) are purchased in that other Contracting State (and such goods or merchandise are not subjected to processing outside that other Contracting State) then such resident shall be considered to have a permanent establishment in that other Contracting State, if all or part of such goods or merchandise is sold by or on behalf of such resident for use, consumption or disposition in that other Contracting State.

On the other hand, notwithstanding the provisions of paragraphs (4) and (5), paragraph (6) provides that a resident of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such resident engages in industrial or commercial activity in such other Contracting State through a broker, general commission agent, or any other agent of an independent status, where such broker or agent is acting in the ordinary course of his business.

Under paragraph (7), the fact that a resident of one Contracting State is a related person with respect to a resident of the other Contracting State or with respect to a person who engages in industrial or commercial activity in that other Contracting State (whether through a permanent establishment or otherwise) shall not be taken into account in determining whether the resident of the first-mentioned Contracting State has a permanent establishment in that Contracting State. As defined in Article 11 (Related Persons), a person is related to another person if either person owns or controls directly or indirectly the other, or if any third person owns or controls directly or indirectly both such persons.

Paragraph (8) provides that the principles set forth in this article are to be applied in determining whether there is a permanent establishment in a State other than one of the Contracting States or whether a person other than a resident of one of the Contracting States has a permanent establishment in one of the Contracting States. This is necessary for the proper application of paragraph (2) of Article 6 (Source of Income). This paragraph is not intended to extend the benefits of the Convention to persons other than residents of the two Contracting States.

ARTICLE 10. SHIPPING AND AIR TRANSPORT

The Article provides that, notwithstanding Article 8 (Business Profits), income derived by a resident of one of the Contracting States from the operation in international traffic of ships or aircraft will be exempt from tax by the other Contracting State. Income derived from the operation in international traffic of ships or aircraft is defined to include income incidental to such operation, such as income derived from the use or lease of containers, trailers from the inland transportation of containers and other related equipment. It does not, however, include other income from the inland transportation of containers.

This article is subject to the saving clause of paragraph (4) of Article 4 (General Rules of Taxation). Therefore, a Contracting State may tax the income from international traffic derived by a resident of the other Contracting State without regard to this article if such resident is a citizen of the first-mentioned Contracting State.

ARTICLE 11. RELATED PERSONS

This article complements section 482 of the Code and confirms the authority of the United States under that section. Where a person subject to the taxing jurisdiction of one of the Contracting States and any other person are related and where such related persons make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, undr paragraph (1) any income, deductions, credits or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income or loss of, or the tax payable by, one of such persons, may be taken into account in computing the amount of the income subject to tax and the taxes payable by such person.

It is anticipated that if an adjustment is made in accordance with paragraph (1) by a Contracting State to the income of one of its residents, the other

Contracting State will, if it agrees with such redetermination and if necessary to prevent double taxation, make a corresponding adjustment to the income of a person in such other Contracting State related to such resident. If the other Contracting State disagrees with the redetermination, it is intended that the two Contracting States will endeavor to reach agreement in accordance with the mutual agreement procedure in Article 27 (Mutual Agreement Procedure).

Paragraph (2) provides that for purposes of the Convention a person is related to another person if either owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both. "Control" includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

ARTICLE 12. DIVIDENDS

Paragraph (1) provides that dividends derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both Contracting States. However, paragraph (2) limits the rate of tax imposed by the Contracting State of source to a rate not in excess of fifteen percent of the gross amount of the dividend. If the dividend recipient is a corporation, the rate of tax imposed by the Contracting State of source may not exceed ten percent of the gross amount of the dividend if during the part of the paying corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year (if any), at least ten percent of the outstanding shares of the voting stock of the paying corporation was owned by the recipient corporation, and not more than twenty-five percent of the gross income of the paying corporation for such prior taxable year (if any) consists of interest or dividends (other than interest derived from the conduct of a banking, insurance, or financing business and dividends or interest received from subsidiary corporations, fifty percent or more of the outstanding shares of the voting stock of which is owned by the paying corporation at the time such dividends or interest is received). These rate limitations do not affect the taxation of profits of the corporation which pays the dividends.

Paragraph (3) provides that the limitations of paragraph (2) will not apply if the dividend recipient, being a resident of one Contracting State, has a permanent establishment in the other Contracting State and the shares with respect to which the dividends are paid are effectively connected with the permanent establishment. In such a case, the dividends will be treated as industrial or commercial profits subject to Article 8 (Business Profits). If the dividend recipient is a citizen of the source Contracting State, that Contracting State may tax the recipient without regard to this article because of the saving clause of paragraph (4) of Article 4 (General Rules of Taxation).

ARTICLE 13. INTEREST

Paragraph (1) provides that interest derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both Contracting States.

Paragraph (2) provides that the rate of tax imposed by one of the Contracting States on interest derived from sources within that State by a resident of the other Contracting State shall not exceed 12 percent of the gross amount of the interest.

Paragraph (3) provides that, notwithstanding paragraphs (1) and (2), interest derived from sources within one of the Contracting States shall be exempt from tax by that Contracting State if it is beneficially derived by the Government of the other Contracting State, by any local authority thereof, the central bank of that other Contracting State, or any instrumentality wholly owned by that Government or that central bank or both, not subject to tax by that other Contracting State on its income. In the case of the United States, examples of "instrumentalities" wholly owned by the government are the Export-Import Bank and the Overseas Private Investment Corporation. The "central bank" in the case of Korea would be the Bank of Korea, and in the case of the Uniated States, the Federal Reserve Banks.

Paragraph (4) provides that paragraph (2) will not apply if the interest recipient, being a resident of one Contracting State, has a permanent establishment in the other Contracting State and the indebedtedness giving rise to the interest is effectively connected with the permanent establishment. In such a

case, the interest will be treated as industrial or commercial profits subject to Article 8 (Business Profits).

If excessive interest is paid to a related person, paragraph (5) provides that the provisions of the article do not apply to the excessive portion of the payment. The excessive portion may be taxed by each Contracting State according to its own law, including the provisions of the Convention where applicable. In the case of the United States, the excessive portion may be taxed as a dividend, in which case the provisions of Article 12 (Dividends) will apply.

Paragraph (6) defines the term "interest" for purposes of the Convention as income from bonds, debentures, Government securities, notes, or other evidences of indebtedness, whether or not secured and whether or not carrying a right to participate in profits, and debt-claims of every kind, as well as all other income which, under the taxation law of the Contracting State in which the income has its source, is assimilated to income from money lent.

This article is subject to the saving clause of paragraph (4) of Article 4 (General Rules of Taxation). Therefore, interest derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this article.

ARTICLE 14. ROYALTIES

Paragraph (1) provides that tax imposed by one of the Contracting States on royalties derived from sources within that Contracting State by a resident of the other Contracting States shall not exceed 15 percent of the gross amount thereof, except as provided in paragraphs (2) and (3).

Under paragraph (2) royalties derived from copyrights, or rights to produce or reproduce any literary, dramatic, musical, or artistic work, by a resident of one Contracting State, as well as royalties received as consideration for the use of, or the right to use, motion picture films including films and tapes used for radio or television broadcasting, may not be taxed by the other Contracting State at a rate of tax which exceeds 10 percent of the gross amount of the royalties.

Paragraph (3) provides that paragraphs (1) and (2) will not apply if the royalty recipient, being a resident of one Contracting State, has in the other Contracting State a permanent establishment and the property or rights giving rise to the royalty is effectively connected with such permanent establishment. In such a case, the royalty will be treated as industrial or commercial profits subject to Article 8 (Business Profits).

Paragraph (4) defines the term "royalties" as payment of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, copyrights of motion picture films or films or tapes used for radio or television broadcasting, patents, designs, models, plans, secret processes or formulas, trademarks, or other like property or rights, or knowledge, experience, or skill (know-how), or ships or aircraft (but only if the lessor is a person not engaged in the operation in international traffic or ships or aircraft). The term also includes gains derived from the sale, exchange, or other disposition of any such property or rights (other than ships or aircraft) to the extent the amounts realized on such sale, exchange or other disposition for consideration are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not so contingent, the provisions of Article 16 (Capital Gains) will apply. The term "royalties" as used in the Convention does not include any royalties, rentals or other amounts paid in respect of the operation of mines, quarries, or other natural resources, which are covered by Article 15 (Income from Real Property).

If excessive royalties are paid to a related person, paragraph (5) provides that the provisions of the article do not apply to the excessive portion of the royalty. The excessive portion may be taxed by each Contracting State according to its own law, including the Convention where applicable. Thus, in the case of the United States, the excessive portion may be treated as a dividend or interest, or in whatever other manner is appropriate.

As noted under paragraph (3) of Article 6 (Source of Income), royalties described in paragraph (4), including contingent gains, will be treated as income from sources within a Contracting State only to the extent they are payments for the use of, or the right to use, property or rights described in paragraph (4) within that Contracting State.

This article is subject to the saving clause of paragraph (4) of Article 4 (General Rules of Taxation). Therefore, royalties derived by a citizen of the

source Contracting State may be taxed by that Contracting State without regard to this article.

ARTICLE 15. INCOME FROM REAL PROPERTY

Under paragraph (1), income from real property, including royalties and other payments in respect of the exploitation of natural resources and gains derived from the sale, exchange or other disposition of such property or of the right giving rise to such royalties or other payments, may be taxed by the Contracting State in which the real property or natural resources are situated. However, income from real property does not include interest on indebtedness secured by real property (e.g., mortgages) or secured by a right giving rise to royalties or other payments in respect of the exploitation of natural resources. Such interest income is covered by Article 13 (Interest).

Paragraph (1) applies to income derived from the usufruct, direct use, letting, or use in any other form of real property.

ARTICLE 16. CAPITAL GAINS

Under paragraph (1), a resident of one Contracting State will be exempt from tax by the other Contracting State on gains from the sale, exchange, or other disposition of capital assets, e.g., stock or securities. However, the exemption does not apply if (1) the gain is from the sale, exchange or other disposition of property described in Article 15 (Income from Real Property) situated within the other Contracting State; (2) the recipient of the gain has a permanent establishment in the other Contracting State and the property giving rise to the gain is effectively connected with the permanent establishment or (3) the individual recipient of the gain mainstains a fixed base in the other Contracting State for a period or periods aggregating 183 days or more during the taxable year and the property giving rise to the gain is effectively connected with the fixed base, or the individual recipient of the gain is present in the other Contracting State for a period or periods aggregating 183 days or more during the taxable year. The term "day" for purposes of the physical presence tests contained in the Convention with respect to an individual means a calendar day during any portion of which the individual is physically present in the relevant Contracting State.

Under paragraph (2), the provisions of Article 15 (Income from Real Property) will apply to real property gains, and the provisions of Article 8 (Business Profits) will apply to gains effectively connected with a permanent establishment.

If the recipient of the gain is a citizen of the other Contracting State, that Contracting State may tax the recipient without regard to this article because of the saving clause of paragraph (4) of Article 4 (General Rules of Taxation).

ARTICLE 17. INVESTMENT OR HOLDING COMPANIES

This article provides that a corporation of one Contracting State deriving dividends, interest, royalties or capital gains from sources within the other Contracting State will not be entitled to the benefits of Articles 12 (Dividends), 13 (Interest), 14 (Royalties) or 16 (Capital Gains) if by reason of special measures the tax imposed on such corporation by the first-mentioned Contracting State with respect to such dividends, interest, royalties or capital gains is substantially less than the tax generally imposed by such Contracting State on corporate profits, and twenty-five percent or more of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States, to be owned, directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State (or, in the case of a Korean corporation, who are citizens of the United States). For purposes of applying this article it is intended that the requisite direct or indirect ownership be tested at the individual shareholder level.

The purpose of this article is to deal with potential abuse which could occur if one of the Contracting States provided preferential rates of tax for investment or holding companies. In the absence of this Article, residents of third countries could organize a corporation in the Contracting State extending the preferential rates for the purpose of making investments in the other Con-

tracting State. The combination of low tax rates in the first Contracing State and the reduced rates or exemptions in the other Contracting State would enable the third country residents to realize unintended benefits. Existing Code provisions dealing with the taxation of capital gains do not make this Article applicable with respect to capital gains.

ARTICLE 18. INDEPENDENT PERSONAL SERVICES

In dealing with the taxation of income from personal services the Convention distinguishes between "independent" and "dependent" personal services. Personal services performed in an independent capacity, or independent personal services, are services performed by an individual for his own account where he receives the income and bears the losses arising from such services. If an individual is an independent contractor he is considered as rendering independent personal services. Generally, services rendered by physicians, lawyers, engineers, architects, dentists and accountants performing personal services as sole proprietors or partners are independent personal services.

Under paragraph (1), income derived by an individual resident of one Contracting State from the performance of personal services in an independent capacity may be taxed by that contracting State. Except as permitted by paragraph (2), such income will be exempt from tax by the other Contracting State.

Under paragraph (2) such income derived in the other Contracting State may be taxed by that other Contracting State if (1) the individual is present therein for a period or periods aggregating 183 days or more in the taxable year; (2) the income exceeds $3,000 or its equivalent in Korean won in the taxable year; or (3) the individual maintains a fixed base therein for a period or periods aggregating 183 days or more in the taxable year (but only on such income attributable to the fixed base). Under paragraph (4) of Article 4 (General Rules of Taxation), the other Contracting State may also tax any individual who is a citizen of that Contracting State without regard to this article.

ARTICLE 19. DEPENDENT PERSONAL SERVICES

Under paragraph (1), subject to Articles 20 (Teachers), 21 (Students and Trainees), 22 (Governmental Functions) and 23 (Private Pensions and Annuities), wages, salaries, and similar remuneration derived by a individual who is a resident of one Contracting State from labor or personal services performed as an employee may be taxed by that Contracting State. Except as provided by paragraph (2), such remuneration derived from sources within the other Contracting State may also be taxed by that other Contracting State. It is intended that for purposes of the Convention the term "wages, salaries and similar remuneration" ncludes ncome from servces performed as an officer of a corporation.

Under paragraph (2) such remuneration derived by an individual resident of one Contracting State will be exempt from tax by the other Contracting State if: (a) the individual is present in that other Conracting State for a period or periods aggregating less than 183 days in the taxable year; (b) the individual is an employee of a resident of the first-mentioned Contracting State or of a permanent establishment maintained in the first-mentioned Contracting State by a resident of a State other than that first-mentioned State; (c) the remuneration is not borne as such by a permanent establishment which the employer has in that other Contracting State; and (d) the income does not exceed $3,000 or its equivalent in Korean won. Such income may nevertheless be taxed by that other Contracting State if the individual is a citizen of that Contracting State, because of paragraph (4) of Article 4 (General Rules of Taxation).

Under paragraph (3), notwithstanding paragraph (2), remuneration derived by an individual from the performance of labor or personal services as an employee aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be exempt from tax by the other Contracting State if such individual (even if a resident of a State other than a Contracting State) is a member of the regular complement of the ship or aircraft. However, this paragraph is also subject to the saving clause of paragraph (4) of Article 4 (General Rules of Taxation) so that the other Contracting

State may tax a citizen or resident of that other Contracting State without regard to this paragraph.

ARTICLE 20. TEACHERS

Paragraph (1) provides that where a resident of one Contracting State is invited by the Government of the other Contracting State, a political subdivision, or a local authority thereof, or by a univessity or other recognized educational institution in that other Contracting State to come to that other Contracing State for a period not expected to exceed two years for the purpose of teaching or engaging in research, or both, at a university or other recognized educational institution, and such resident comes to that other Contracting State primarily for such purpose, his income from personal services for teaching or research at the university or educational institution will be exempt from tax by that other Contracting State for a period not exceeding two years from the date of his arrival in that other Contracting State.

Since a temporary visit may be of such a duration that an individual may lose his status as a resident of the Contracting State of which he was a resident at the time he became eligible for the benefits of this article, the individual need only be a resident of such Contracting State at the beginning of his visit. However, if the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this article. See paragraphs (4) and (5)(b) of Article 4 (General Rules of Taxation). If the individual's visit exceeds a period of two years from the date of his arrival, the exemption applies only to the income received by the individual before the expiration of such two year period.

Pursuant to paragraph (2), this article does not apply to income from research undertaken primarily for the private benefit of a specific person or persons.

ARTICLE 21. STUDENTS AND TRAINEES

Paragraph (1) provides that an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for the primary purpose of studying at a university or other recognized educational institution in that other Contracting State, securing training required to qualify him to practice a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization, will be exempt from tax by that other Contracting State for a period not exceeding five taxable years from the date of his arrival in that other Contracting State on:

(1) Remittances from abroad for the purpose of his maintenance, education, study, research or training;

(2) The grant, allowance, or award; and

(3) Income from personal services performed in the other Contracting State not in excess of $2,000 or its equivalent in Korean won for any taxable year.

Under paragraph (2), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein as an employeee of, or under contract with, a resident of the first-mentioned Contracting State, for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned Contracting State or other than a person related to such resident, or studying at a university or other recognized educational institution in that other Contracting State, will be exempt from tax by that other Contracting State for a period of twelve consecutive months, on income from personal services not in excess of $5,000 or its equivalent in Korean won.

Under paragraph (3), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for a period not exceeding one year, as a participant in a program sponsored by the other Contracting State, for the primary purpose of training, research, or study, will be exempt from tax by the other Contracting State with respect to his income from personal services in respect of such training, research, or study performed in that other

Contracting State in an aggregate amount not in excess of $10,000 or its equivalent in Korean won.

Under paragraph (4), the benefits provided in paragraph (1) and the benefits provided under Article 20 (Teachers) may extend only for such period of time, not to exceed five taxable years from the date of the individual's arrival, as may reasonably or customarily be required to effectuate the purpose of the visit.

If an individual qualifies for the benefits of more than one of the provisions of Articles 20 (Teachers) and 21 (Students and Trainees), such individual may choose the most favorable provision but may not claim the benefits of more than one provision in any taxable year as a means of avoiding the limitations provided. Thus, for example, an individual who comes to the other Contracting State for the primary purpose of studying may be able to qualify under either paragraph (2) or (3) of this article. However, he cannot combine the maximum exclusion limits in those two paragraphs to exclude $15,000 during the taxable year. The exclusions permitted by the Convention are in addition to any exclusions, exemptions, deductions, credits or other allowances to which the individual is entitled under the laws of the Contracting States. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard of this article. See paragraphs (4) and (5)(b) of Article 4 (General Rules of Taxation).

ARTICLE 22. GOVERNMENTAL FUNCTIONS

Under this article, wages, salaries, and similar remuneration, including pensions or similar benefits, paid from public funds of one Contracting State to a citizen of that Contracting State for labor or personal services performed as an employee of that Contracting State or instrumentality thereof in the discharge of governmental functions will be exempt from tax by the other Contracting State.

If the citizen becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this article. See paragraphs (4) and (5)(b) of Article 4 (General Rules of Taxation).

ARTICLE 23. PRIVATE PENSIONS AND ANNUITIES

Except as provided in Article 22 (Governmental Functions), pensions and other similar remuneration paid to an individual who is a resident of a Contracting State in consideration of past employment will be taxable under paragraph (1) only in that Contracting State. Thus, private pensions and similar remuneration derived from sources within one Contracting State by an individual resident of the other Contracting State in consideration of past employment are exempt from tax in the first-mentioned Contracting State. The term "pensions and other similar remuneration" is defined in paragraph (3) as periodic payments made after retirement or death in consideration for services rendered, or by way of compensation for injuries received in connection with past employment. The term does not include social security payments covered in Article 24 (Social Security Payments).

Paragraph (2) provides that alimony and annuities paid to an individual resident of a Contracting State will be taxable only in that Contracting State. The term "annuities" is defined in paragraph (4) as 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 (other than for services rendered). The term "alimony" is defined in paragraph (5) as periodic payments made pursuant to a decree of divorce, separate maintenance agreement, or support or separation agreement which is taxable to the recipient under the internal laws of the Contracting State of which he is a resident. Thus, the term "alimony" would not include a payment which would not be taxable to the recipient under the laws of the Contracting State in which the recipient is a resident even though such payment is made pursuant to a decree of divorce or of separate maintenance agreement.

This article is subject to the savings clause of paragraph (4) of Article 4 (General Rules of Taxation). Therefore, individuals who are citizens of a

Contracting State may be taxed by that Contracting State without regard to this article.

ARTICLE 24. SOCIAL SECURITY PAYMENTS

This article provides that social security payments and other public pensions, e.g., railroad retirement benefits, paid by one Contracting State to an individual who is a resident of the other Contracting State (or in the case of such payments by Korea, to an individual who is a citizen of the United States, i.e., such payments by Korea to United States citizens or residents will be exempt from tax by the United States) will be taxable only in the first-mentioned Contracting State. Payments described in Article 22 (Governmental Functions) are not covered by this article.

ARTICLE 25. EXEMPTION FROM SOCIAL SECURITY TAXES

This article provides an exemption from social security taxes for Korean residents working in Guam, on a temporary nonimmigrant basis, similar to the exemption contained in the Internal Revenue Code for residents of the Philippines working in Guam.

Specifically, paragraph (1) provides for an exemption from taxes imposed under Chapter 21 of the Internal Revenue Code with respect to wages paid for services performed in Guam by a resident of Korea while in Guam on a temporary basis as a nonimmigrant alien admitted to Guam pursuant to section 101(a)(15)(H)(ii) of the United States Immigration and Nationality Act (8 U.S.C. 1101(a)(15)(H)(ii)).

Paragraph (2) provides that this exemption shall continue only so long as the similar exemption for residents of the Republic of the Philippines provided by section 3121(b)(18) of the Internal Revenue Code.

ARTICLE 26. DIPLOMATIC AND CONSULAR OFFICERS

This article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements. This is merely a special case of the general rule provided in paragraph (2) of Article 4 (General Rules of Taxation).

ARTICLE 27. MUTUAL AGREEMENT PROCEDURE

When a resident of one Contracting State considers that the action of one or both Contracting States results or will result for him in taxation not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident. A resident of a Contracting State need not, although it is anticipated that in the normal situation he will, exhaust his other administrative or judicial remedies prior to resorting to the use of the mutual agreement procedure. If the claim is considered to have merit by the competent authority, that competent authority must endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation contrary to the Convention.

Paragraph (2) requires the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may agree to the same attribution of industrial or commercial profits to a resident of one Contracting State and its permanent establishment situated in the other Contracting State; the same allocation of income, deductions, credits, or allowances between a resident of one Contracting State and any related person; the same determination of the source of particular items of income; uniform accounting for income and deductions; and the same meaning of any term used in this Convention.

Under paragraph (3), the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions, for the purpose of reaching an agreement.

Under paragraph (4), in cases in which the competent authorities reach an agreement, taxes will be imposed on such income, and refund or credit of

taxes allowed, by the Contracting States in accordance with such agreement. This permits the issuance of a refund or credit notwithstanding procedural barriers otherwise existing under a Contracting State's law, such as the statute of limitations. However, it does not authorize imposition of additional taxes after the statute of limitations has run.

ARTICLE 28. EXCHANGE OF INFORMATION

Paragraph (1) provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information pertinent to the carrying out of the Convention and for the prevention of fraud or for the administration of statutory provisions concerning taxes to which this Convention applies provided the information is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes.

Under paragraph (2) information exchanged must be treated as secret and cannot be disclosed except when disclosed to persons concerned with, or made part of a public record with respect to the assessment, collection, enforcement or presecution in respect of taxes which are the subject of the Convention. Thus, disclosure is not prohibited as a part of a public proceeding before a court or administrative body.

Under paragraph (3) no information shall be exchanged which would be contrary to public policy.

Under paragraph (4) and if specifically requested by the competent authority of one of the Contracting States, the competent authority of the other Contracting State shall provide information in the form of depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

Under paragraph (5) the exchange of information may be on either a routine basis or on request with reference to particular cases. The competent authorities may agree on the list of information to be furnished on a routine basis.

Paragraphs (6) and (7) provide for notification and text transmittal at least once a year of amendments of the tax laws referred to in paragraph (1) of Article 1 (Taxes Covered), of adopted taxes referred to in paragraph (2) of that article, or of published material concerning application of the Convention, whether in the form of regulations, rulings or judicial decisions.

Under paragraph (3) of Article 1 (Taxes Covered), the provisions of this article extend to taxes of every kind imposed at the National level.

ARTICLE 29. EXTENSION TO TERRITORIES

Under paragraph (1), either Contracting State may, at any time while the Convention continues in force, by a written notification given to the other Contracting State through diplomatic channels, declare its desire that the Convention, either in whole or in part or with such modifications as may be found necessary for special application in a particular case, shall extend to all or any of the areas (to which the Convention is not otherwise applicable) for whose international relations it is responsible and which impose taxes substantially similar in character to those which are the subject of the Convention. When the other Contracting State has, by a written communication through diplomatic channels, signified to the first-mentioned Contracting State that such notification is accepted in respect of such area or areas, and the notification and communication have been ratified and instruments of ratification exchanged, the Convention, in whole or in part, or with such modifications as may be found necessary for special application in a partciular case, as specified in the notification, will apply to the area or areas named in the notification and will enter into force and effect on and after the date or dates specified therein. None of the provisions of the Convention will apply to any such area in the absence of such acceptance and exchange of instruments of ratification in respect of that area.

Under paragraph (2), at any time after the date of entry into force of an extension under paragraph (1), either Contracting State may, by six months' prior notice of termination given to the other Contracting State through diplomatic channels, terminate the application of the Convention to any area to which it has been extended under paragraph (1). In such event the Convention will cease to apply and have force and effect, beginning on or after the first day of January next following the expiration of the six-month period, to the area or areas named therein, but without affecting its continued application to the United States, Korea, or to any other area to which it has been extended under paragraph (1).

Pursuant to paragraph (3), in the application of the Convention in relation to any area to which it is extended by notification by Korea or the United States, reference to "Korea" or the "United States", as the case may be, shall be construed as referring to that area.

Under paragraph (4), termination in respect of the United States or Korea of the Convention under Article 32 (Termination) will unless otherwise expressly agreed by both Contracting States, terminate the application of the Convention to any area to which the Convention has been extended under this article by the United States or Korea.

ARTICLE 30. ASSISTANCE IN COLLECTION

This article provides for mutual assistance in the collection of taxes where required to ensure that the benefits of the Convention will only be extended to persons entitled to such benefits. It does not in any way affect rights of residents of the Contracting States under the Convention.

Paragraph (1) provides that each Contracting State will endeavor to collect on behalf of the other Contracting State such taxes imposed by that other Contracting State as will ensure that any exemption or reduced rate of tax granted under the Convention by that other Contracting Satte will not be enjoyed by persons not entitled to such benefits.

Paragraph (2) makes clear, however, that in no case shall this article be construed to impose upon a Contracting State the obligation to carry out measures at variance with the laws, administrative practices, or public policy of either Contracting State with respect to the collection of its own taxes.

ARTICLE 31. ENTRY INTO FORCE

This article provides that the Convention is subject to ratification and for the exchange of instruments of ratification. The Convention will enter into force on the thirtieth day following the exchange of instruments of ratification. The Convention shall first have effect with respect to the rate of withholding taxes and Article 25 (Exemption from Social Security Taxes), to amounts paid on or after the first day of the second month following the date on which this convention enters into force; and with respect to other taxes for taxable years beginning on or after January 1 of the year following the date on which this Convention enters into force.

ARTICLE 32. TERMINATION

This article provides that the Convention will remain in force indefinitely, but that it may be terminated by either Contracting State at any time after five years from the date it enters into force. A Contracting State seeking to terminate the Convention must give at least six months' notice through diplomatic channels. If the Convention is terminated, such termination will be effective with respect to income of taxable years beginning (or, in the case of withholding taxes and social security taxes, payments made) on or after January 1 next following the expiration of the six month period.

EXCHANGE OF NOTES

In notes exchanged at the time of the signing of the treaty the United States noted that the Korean Government had stressed the need for provisions in the Convention which would constitute special incentives to promote the flow of United States capital and technology to Korea. While observing that the

United States could not agree to such provisions, the United States did offer assurances that, when circumstances permit, the United States would be prepared to resume discussions with a view to incorporating provisions into the Convention which will minimize the interference of the United States tax system with incentives offered by the Government of Korea. These provisions would be consistent with income tax policies of the United States Government regarding other developing countries.

In the same exchange of notes, the Korean Government confirmed that the definition of Korean tax in paragraph (1) of Article 1 of the Convention includes the Korean Defense Tax assessed on the taxes referred to in that definition, i.e., the Korean Income Tax and Corporation Tax. The Defense Tax is levied as a surcharge on a number of Korean taxes including the income tax and the corporation tax. The treaty applies only to those parts of the Defense Tax levied with respect to the income and corporation taxes.

TELEGRAM

Hon. JOHN J. SPARKMAN
U.S. Senate, Dirksen Senate Office Building,
Washington, D.C.

DEAR SENATOR SPARKMAN: Since our separate letters to you on July 21, 1976, and April 1, 1977, regarding the United States-United Kingdom Tax Treaty, we have been informed that the revenue loss to California will be far less than $100 to $125 million originally indicated. The direct loss of tax revenue to California resulting from the exclusion of the foreign operations of foreign parent corporations from the unitary method of taxation may be 15 or 20 million dollars.

Furthermore, it is the judgment of California's Business and Transportation Secretary, Richard Silberman, and the State Director of Finance, Roy Bell, that ratification of the treaty will have a positive net economic impact on California.

Secretary of the Treasury Blumenthal has specifically requested our support for ratification of the treaty and has emphasized that the Carter Administration believes it to be in the international interest.

In light of the above, it is our judgment that it is in the best interest of California as well as the nation that the United States-United Kingdom Tax Treaty be ratified.

Sincerely,

EDMUND G. BROWN, JR.,
Governor.
ALAN CRANSTON,
U.S. Senate.

OFFICE OF THE GOVERNOR,
STATE CAPITOL,
Boise, Idaho, May 2, 1977.

HON. JAMES A. MCCLURE,
Dirksen Building,
Washington, D.C.

DEAR JIM: In June of 1976, former Governor Cecil D. Andrus wrote to you urging that you oppose ratification of the proposed United States-United Kingdom Tax Treaty because that treaty contained provisions placing restrictions on state tax authority which are unacceptable to Idaho and a number of other states. I wish to advise you that I support former Governor Andrus' position.

I also wish to draw your attention to the March 8, 1977, recommendations of the Task Force on Foreign Source Income of the House Committee on Ways and Means. The report recommends placing limitations on state tax authority similar to those proposed in the U.S.-U.K. Tax Treaty. These recommendations are not in the best interest of the state of Idaho or of state and local governments generally.

The problem is how to accurately locate the source of income earned by corporate taxpayers engaged in international commerce. State methods of

"sourcing" income are very different from the method adopted by the Internal Revenue Code. The states have been forced to struggle with this difficult problem for many decades in regard to taxation of interstate commerce. As the result of hard experience and much litigation, all states have adopted some method of attributing income by means of formulas measuring the extent of income producing activity occurring within the state. The most common formula, and the one used in Idaho, is based upon the ratio of property, payroll and sales occurring within the state to that which occurs outside the state. A growing number of states apply this concept not only to single corporations but also to multicorporate structures subject to common ownership, operation and control. Experience has shown this "combined reporting" system of computing income provides a fairly accurate computation of the income attributable to the taxing state. The practice has been affirmed by many courts including those in Idaho. More and more states are extending the practice not only to corporations engaged in interstate commerce but also those engaged in international commerce.

Contrasted to this state practice is the federal policy reflected in the Internal Revenue Code. The Code attempts to source income on a separate accounting basis by treating the operation in each foreign country as if it were a separate and independent business. An accurate computation of income under this method requires close analysis of intercompany transfers and the recomputation of income and expenses where those items do not reflect true arms-length transactions, as is often the case between affiliated corporations.

Both the proposed U.S.-U.K. Tax Treaty and the recommendation of the Task Force on Foreign Source Income would require the states to adopt the federal source of income philosophy and apply it to taxpayers engaged in international commerce. I urge you to oppose these proposals.

Imposing upon the states provisions similar to those found in Section 482 of the Internal Revenue Code for sourcing income is to impose an impossible administrative burden upon many states—particularly smaller states such as Idaho. Section 482 and the Treasury regulations promulgated thereunder are among the most complex provisions of our already overcomplicated income tax laws. The Task Force recommendation itself acknowledges that the federal approach, "already produces significant problems when applied at the federal level." The Internal Revenue Service has found Section 482 to be extremely difficult to administer because of the large amount of auditing required to insure that intercompany transactions are reported on an arms-length basis. The problem presented to the states—which lack the vast audit resources available to the IRS—is impossible.

It must also be noted that the states collectively have much more experience with the problem of sourcing income than does the federal government. We believe that the state philosophy of sourcing income by means of a mathematical formula related to income producing activities is superior to the federal approach of piecemeal review and adjustment of individual transactions. The formula method is easier to administer, requires far less audit activity to enforce and greatly reduces the ability of taxpayers to arbitrarily lessen tax liability by manipulating intercompany transactions. The recommendations of the Task Force and the proposals of the U.S.-U.K. Tax Treaty would impose upon the states a method of attributing income to its source which is developed on far less actual experience than is the states' formula apportionment concept.

Finally, as you are no doubt aware, it has been federal legislative and judicial policy to refrain from interference with the general subject matter of state taxation. In recent years, large strides toward uniformity among the states in the formula to be used for attributing income have been made. Further progress is needed but it is the states and not the federal government which possess the capacity, through continued experience and future reform, to reach the fairest, most equitable and practicable method of attributing income.

For these reasons, I urge you to join with me and with the representatives from other states in opposing both the ratification of the proposed U.S.-U.K. Tax Treaty and the adoption of the recommendations of the Task Force on Foreign Source Income.

Sincerely,

JOHN V. EVANS,
Governor.

STATE OF IDAHO,
OFFICE OF THE GOVERNOR,
Boise, Idaho, June 16, 1976.

Hon. JAMES A. MCCLURE,
Dirksen Building,
Washington, D.C.

DEAR JIM: I have recently learned of two related matters pending before Congress which cause me concern. Each would significantly affect a longstanding provision of the Idaho Income Tax Act and important tax practices followed by Idaho and several other states.

The first of these is the revised United States-United Kingdom Tax Treaty which we understand has been or will be submitted to the Senate for ratification. The second is a proposed amendment to the Tax Reform Bill (H.R. 10612) now before the Senate Finance Committee.

To understand the problem, you must consider some background. In recent years many states and tax administrators have been trying to resolve the problem of determining what portion of a multistate or multinational corporation's income is to be attributed to a particular taxing state. The problem is to compute the amount attributable tot he taxpayers' activities wtihin the state without at the same time taxing extraterritorial values. The goal is to insure full accountability on the part of these corporations to all of the states in which they do business without creating double taxation. Compounding the problem are the complex multicorporate structures through which most of the largest business enterprises now conduct their business activities. It is far too easy, by manipulating the prices charged for intercompany transfers within such organizations, for taxpayers to arbitrarily minimize their exposure to state taxes. Accordingly, more and more states have turned to requiring these enterprises to file combined state income tax returns. By viewing these multicorporate structures as a single economic unity—which in reality they are—the states have been able to more accurately determine that unity's true income and apportion that income which should, in fairness, be attributed to the taxing state.

California has been a leader in this concept and its combined reporting statutes have been judicially affirmed as being a fair and constitutional method of attributing income to California. It has used the concept for more than thirty years. More and more states, including Idaho, have been following California's lead. More recently, the creation of the Multistate Tax Commission (of which Idaho is a member) has been a major step toward uniform state practices in this area.

As you may be aware, there have been pending before Congress over the last few years a number of bills proposing that Congress establish by federal law the method by which states shall attribute income for tax purposes. The various bills have been generally supported by industry and opposed by the states. Extensive Congressional hearings and studies have been conducted commencing with the Willis Committee report in the House of Representatives in 1966. Despite these extensive hearings and the many bills which have been proposed, Congress has declined to act in this area, thereby leaving the states free to work out among themselves fair, equitable and uniform methods of apportioning income of multistate and multinational corporations. An increasing number of states are adopting some form of combined reporting. The concept has generally been affirmed by the state and federal courts, including those in Idaho.

The proposed U.S.-U.K. Treaty contains provisions which would prohibit computing state income taxes on a combined basis, when the taxpayer has activities in the United Kingdom. Since virtually all major corporations have such activities the treaty would effectively destroy the unitary reporting concept.

The proposed amendment to the Tax Reform Bill now pending in the Senate Finance Committee would create similar but broader restrictions.

We vigorously oppose both the treaty restrictions and the proposed amendment to the Tax Reform Bill.

The treaty would have the effect of enacting provisions which Congress has been unwilling to create by statute. It appears to be a backdoor effort to create limitations on state taxing authority which industry has been unable to gain

from Congress directly in the form of legislation. It should be noted that in spite of the obvious effect on state tax systems, the treaty was negotiated without consulting any state or state tax officials.

Either the treaty or the amendment, if enacted, would arbitrarily isolate from the computational formula for apportioning income an organization's overseas activities. This will present large and lucrative shelters for these organizations from state taxation. It will result in significant loss in state revenue. The alternative which would be forced upon the states would be to adopt provisions essentially similar to those found in Section 482 of the Internal Revenue Code and the conceptually linked foreign tax credit. Section 482 and the Treasury Regulations in our already overcomplicated income tax laws. The Internal Revenue Service, with its massive audit staff, is itself unable to properly enforce it. The problem presented the states, with far smaller resources, is many times more complicated. It would require an adjustment of transactions in interstate commerce as well as transactions conducted in international trade. To expect a state to protect its revenue sources by recomputing income to reflect "arm's length" transactions is to expect the impossible. We believe, therefore, that for state tax purpose combined reporting is both conceptually superior and pragmatically simpler than the source of income rules currently reflected in the Internal Revenue Code.

The restrictions being proposed on state tax authorities would also appear to be contrary to policies now being discussed in Congress regarding federal taxation. It would appear to be contrary, for example, to the movement currently before Congress to reduce the federal tax advantage enjoyed by domestic international sales corporations (DISCS).

It also seems inconsistent to so restrict an important state tax revenue source at the same time Congress is considering reducing or eliminating revenue sharing.

We must additionally point out that it seems inappropriate to include restrictions upon the methods of computing state taxation in the Tax Reform Bill relating only to federal taxes.

Finally, the action proposed is contrary to long established and recognized federal legislative and judicial policy against interference with the general subject matter of state taxation. States have in recent years made significant progress in attempting to resolve the problems inherent in taxing major corporate taxpayers with worldwide activities. Although much remains to be done, important steps have been taken toward establishing uniform practices among the states and toward preventing both over and under taxation of income. No federal agency can match the collective experience of state tax authorities in this area. To create national restrictions dictating to the states the method by which they shall determine income earned from sources within a state would be to destroy the progress which has been made. It would impose on the states a concept impossible to administer and would eliminate the ability of the states to find by experience and reform newer and better methods of resolving these complex problems.

For these reasons we urge that you oppose both the ratifications of the United Kingdom Treaty and the proposed restrictive provisions of the Tax Reform Bill.

Sincerely,

CECIL D. ANDRUS,
Governor.

STATEMENT OF ARTHUR C. ROEMER, COMMISSIONER OF REVENUE, STATE OF MINNESOTA

Mr. Chairman and members of the Committee: I would like to thank you for the opportunity to make a statement and to express my concerns as a state tax administrator about a provision in this treaty which is before you today. It is my concern that this treaty, if ratified by the Senate of the United States, may act to deprive the individual states of the right to effectively tax a multinational corporation.

In the administration of the Minnesota Corporate Income Tax, the corporate audit section has become acutely aware that a multinational corporation may

deal with its affiliates in such a manner as to distort that income properly assignable to Minnesota or any other state. If our auditors determine that there is a basis for believing that the income is being distorted through special arrangements or agreements, Minnesota law provides that we can require such consolidated statements as are necessary to determine the taxable net income received by any one of the affiliated or related corporations. The combined income is reallocated to the various companies included in the combination by employing our statutory, three factor formula. This unitary concept, we feel, is the most efficient and expeditious tool to reallocate the companies overall unitary profits. The provisions of Article 9(4) would prevent us from using the unitary concept in the administration of the Minnesota Corporate Income Tax.

If there exist pressing reasons to abridge the use of the unitary concept by the individual states, I feel that a treaty is not the appropriate vehicle for such a decision. I would prefer that legislation be introduced in the House of Representatives and the Senate and be referred to the Ways and Means and Finance Committees respectively. Only in this manner, I believe, would this issue receive the expertise and deliberation which it deserves. Hearings after appropriate notice could be held, and the staff members of the committees could thoroughly research the revenue impact.

There are other problems that I can foresee if this treaty containing Article 9(4) is ratified. If we, as administrators of state tax laws, are prohibited from using the unitary concept with respect to income of multinational corporations, we may be forced to abandon the unitary concept with respect to income of domestic corporations under the equal protection clause of the United States Constitution. A court may very well determine that we may not be able to impose a more strict standard on domestic corporations than we are allowed to impose on a multinational corporation.

Will multinational corporations receive preferential treatment in the futuer in other areas of taxation? I feel it is not unreasonable to assume that if Article 9(4) is implemented, other state actions which may be construed to hamper international businesses may be dealt a fate similar to the unitary concept. A next step might logically be to exempt dividends, interest, and other foreign source income derived from a multinational corporation by a United States resident or to prohibit the states from imposing higher standards for safety on imported products than are imposed by the federal government.

Since this treaty is unprecedented in that it is the first tax treaty that I am aware of to directly limit state taxing powers, I believe we are justified in our concerns. As far as I am aware, this treaty was entered into by the Executive Branch without any consultation with the states. The states have become unwilling participants in the treaty provisions. I fear that this treaty, if ratified, will set the stage for other treaty negotiations which will be closed to the states.

I would urge you to carefully examine Article 9(4) with these problems in mind and to determine whether this treaty is a proper vehicle for this drastic measure.

Again, I thank you for your attention to these problems.

STATE OF TENNESSEE,
EXECUTIVE CHAMBER,
Nashville, Tenn., June 21, 1977.

Hon. JOHN SPARKMAN,
Chairman, Senate Foreign Relations Committee, U.S. Senate,
Dirksen Office Building, Washington, D.C.

DEAR SENATOR SPARKMAN: The pending United Kingdom-United States tax treaty is not recommended by the State of Tennessee because paragraph (4) of Article 9 represents an infringement on the right of this State to conceive and to administer its own tax policy. I can perceive of no benefit flowing to the state because of the treaty and to my knowledge there has been no showing of an overriding need of such a national policy at the expense of state's rights.

I would appreciate your making this letter a part of the official hearings on the treaty.

Sincerely,

RAY BLANTON.

U.S. SENATE,
COMMITTEE ON APPROPRIATIONS,
Washington, D.C., July 22, 1977.

Hon. JOHN SPARKMAN,
Chairman, Committee on Foreign Relations,
The Capitol, Washington, D.C.

DEAR MR. CHAIRMAN: I understand that the Foreign Relations Committee is currently conducting hearings on the proposed Tax Convention with the United Kingdom.

I am enclosing a letter from the Governor of Vermont, the Honorable Richard A. Snelling, outlining his views on the treaty and concerns with certain aspects of the treaty, specifically Article 2, Paragraph (2a)(c), and Article 9, Paragraph (4).

I feel that the Governor has raised some valid points concerning the possible effects of the treaty on the states. I hope that your Committee will take his views into account as it considers the treaty and, if possible, make his letter to me a part of the permanent hearing record.

Thank you for your consideration of this matter.

Sincerely,

PATRICK J. LEAHY,
U.S. Senator.

Enclosure.

OFFICE OF THE GOVERNOR,
STATE OF VERMONT,
June 23, 1977.

Hon. PATRICK J. LEAHY,
U.S. Senator, Dirksen Senate Office Building,
Washington, D.C.

DEAR PAT: I want to express to you my serious opposition to the United States/United Kingdom Tax Treaty pending before the Senate, and particularly Article 2, Paragraph (2) (c), and Article 9, Paragraph (4), which would prohibit a state from including in the calculation of income of a multinational corporation certain income earned by corporations domiciled in the United Kingdom. I object to these treaty provisions for two reasons.

First, they represent bad tax law, by creating a significant loophole by which multinational corporations will be able to shield from state corporate income taxes income which should be taken into consideration by the states.

Perhaps more importantly, I'm offended by the proposition that the federal government can, in negotiations with a foreign country to which no states were parties, negotiate away state taxing powers in exchange for federal benefits. This strikes me as an extremely dangerous precedent and one which I trust will trouble you, as representative of a state with a distinguished history of resistance to federal interference in matters which are properly within the purview of a state.

Paul Wickes, the Commissioner of Taxes, would be happy to provide you or your staff with further information concerning our objections to this treaty.

Best wishes.

Sincerely yours,

RICHARD A. SNELLING,
Governor.

COMMONWEALTH OF VIRGINIA,
OFFICE OF THE GOVERNOR,
July 5, 1977.

Hon. JOHN SPARKMAN,
Chairman, Senate Foreign Relations Committee, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR SPARKMAN: I am writing to express my grave concern for the United States-United Kingdom Treaty which will come before your Committee shortly. I am sure that this letter will only echo the comments you have received from other states. However, the precedent that could be set by this treaty is of significant concern to Virginia and all states.

For the first time ever the Treasury Department has negotiated away traditional taxing authority of the several states. It is clear that if the U. K. Treaty is approved by the Congress, all states will soon be prohibited from including in a combined corporation tax report the income or business factors of foreign corporations. Should this be allowed to happen, what guarantee is there that the Treasury Department will not in future negotiations exempt other income such as dividends or interest paid from foreign corporations; or prohibit other states from imposing higher health or safety standards on imported products that are imposed by the Federal Government.

The Senate Finance Committee of the Congress has a special committee studying taxation of foreign source income as well as a continuing staff study of the taxation of multistate income. If the Congress should decide to change the national policy concerning these subjects, the appropriate way is to act through the traditional powers of the Congress and not through the negotiating arm of the Treasury Department.

I would appreciate it if you would convey to the members of your Committee my position that the treaty should be modified to specifically reserve paragraph (2)(c) of Article 2 and paragraph (4) of Article 9. This modification of the treaty is essential to the preservation of the power of the states.

Sincerely,

MILLS E. GODWIN, JR.

PREPARED STATEMENT OF MARY ELLEN MCCAFFREE, WASHINGTON DIRECTOR OF REVENUE

On January 6, 1976, the United States Treasury Department announced in a press release that a new tax treaty has been signed by the governments of the United States and the United Kingdom. The treaty must be submitted to the U.S. Senate for ratification.

The treaty sets out conditions for taxation of income of multinational corporations which operate both in the United States and also through affiliated corporations in the United Kingdom. The treaty, by its terms, extends the limitations on such taxation not only to the United States government, but also to state and local governments within the United States. This inclusion of state governments within limitations of the proposed treaty sets up new federal barriers to state taxation of such multi-national corporations and enhances the incentives which varying individual state tax structures offer to those corporations seeking to minimize or avoid full state tax liability. The State of Washington opposes ratification of the proposed treaty as now drafted and urges modification of offending language in Articles 2 and 9. The recommended modifications would: eliminate application of the proposed international treaty restrictions to the taxing rights of individual states, and allow states to treat all corporate taxpayers doing business within state borders in a similar manner.

MODIFY TREATY LANGUAGE

Paragraph 4 of Article 9 contains language which clearly brings state governments within provisions and restrictions of the proposed treaty ("Contracting State" refers to the governments of United States and the United Kingdom):

"Except as specifically provided in this Article, in determining the tax liability of an enterprise doing business in a Contracting State, *or in a political subdivision or local authority of a Contracting State*, such Contracting State, *political subdivision or local authority* shall not take into account the income, deductions, receipts, or outgoings or a related enterprise of the other Contracting State or of an enterprise of any third State related to an enterprise of the other Contracting State."

In terms of state tax liability, this means only that portion of the multinational corporate structure operating within the United States can be considered for determining tax liability. Operations of affiliated corporations in the United Kingdom and other foreign countries would fall outside any requirement to report income. This language clearly curtails the taxing powers of the states where an attempt is made to apportion the proper amount of the corporate family's total income for the purpose of determining appropriate state tax liability, and insure that all corporations doing business in the state

bear their fair share of taxes without regard to their corporate structure or area of operation.

In addition, it provides a potential tax loophole whereby corporations can shift net income among affiliated or "related" corporations for the purpose of avoiding state tax liability.

Deleting the underlined portion of this paragraph would ensure the continued opportunity now afforded state governments to resolve taxation problems on their own initiative and in a way that is compatible with individual state tax structures.

In order to bring other sections of the proposed treaty into conformity with the above deletion, section (c) of paragraph 2, Article 2 should also be deleted:

"for the purposes of paragraph (4) of Article 9 (Associated Enterprises), taxes imposed on income by political subdivisions or local authorities of a Contracting State."

Deletion of this language would ensure that the prerogatives of the several states would not be affected by the treaty.

POSITION OF THE STATE OF WASHINGTON

The stated purpose of the proposed tax treaty, now subject to U.S. Senate ratification, is ". . . for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains." Although the treaty may serve these purposes for federal income tax liability, it falls short of the goal by exempting the affected multi-national corporations from their fair share of state tax liability.

The corporate net income tax is not currently part of the Washington State tax base, but it has been an integral part of tax reform efforts in the state and remains a viable alternative source of future state revenues. Thus, the treaty provisions pose a threat to the State of Washington in at least three important areas:

1. They restrict the alternatives and methods the state may use for determining corporate income tax liability.

2. They prevent state government from treating all corporate (multi-national, multi-state and local) taxpayers doing business in the state equally with respect to state tax liability.

3. They create a potentially significant erosion of Washington's future tax base with consequent impact on state revenues.

We believe including state governments within provisions of the treaty effectively transforms this agreement into a major piece of federal legislation which goes far beyond the normal scope of the usual bilateral agreements between nations, and may well set a significant (and discriminatory) precedent for tax treaties with other nations. We urge that such sweeping legislation be entered into only after the benefit of the customary public hearings and opportunity for consideration of the views of the states whose rights and taxing powers are being restricted. This is the procedure Congress follows with respect to other major legislative and policy changes.

RESTRICTIONS ON METHODS AND ALTERNATIVES

Although the State of Washington has not yet enacted a state net income tax, several proposals for such a tax have been given substantial consideration in the past few years. All such proposals would have provided for a "combined reporting" method of determining tax liability for multi-state and multi-national corporations operating within Washington. Implementation of this concept requires combining the reports of the taxpayer corporation with the reports of the various other affiliated corporate entities engaged with it in a unitary business activity, regardless of the corporate structure or geographical location of the various subsidiaries.

It involves the combining of both the income totals and the sales, property and payroll factors of the various corporate entities, while excluding transactions between those corporate entities. The purpose and effect of this combination is not to tax out-of-state income, but rather to determine more accurately and fairly the amount of the taxpayer corporation's income which is properly attributable to the state in which it is doing business.

The proposed treaty, as now drafted, would eliminate the presently available prerogative for Washington to require combined reporting for multi-national firms having subsidiary or otherwise affiliated operations in the United Kingdom. Nor may consideration be given to subsidiary operations in *any* foreign country, if that subsidiary is related to an enterprise in the United Kingdom.

THE QUESTION OF EQUITY

Combined reporting of income is a time-tested and successful method (notably by the states of California and Oregon) which allows states to treat all corporate taxpayers in a similar and equal manner, regardless of the corporate structure through which such a taxpayer operates (i.e., whether it operates through one corporation having one hundred divisions or through one parent with ninety-nine subsidiaries). By eliminating the possibility for states to require combined reporting, the proposed treaty provides the affected multi-national firms with the potential ability to shift profits and losses among affiliated corporate entities in the United Kingdom and the United States (and third countries as well) in order to minimize overall total tax liability. This gives a significant tax benefit to such multi-national corporations over domestic corporations, which may not be able to exercise strategic manipulation to exploit differences in individual state and national tax structures. The effect is thus to discriminate, especially insofar as state tax liability is concerned, against the smaller firms by denying them similar advantages enjoyed by the multi-national firms. This has the net effect of requiring domestic corporations to subsidize international corporate operations by bearing a disproportionate share of state and local taxes.

REVENUE IMPACT

Due to the unique nature of Washington's existing business tax (the Business and Occupation Tax on gross receipts), the proposed treaty language would have no immediate impact on present state revenues. This is because current corporate tax liability in Washington is narrowly defined in terms of a taxable nexus within state boundaries, rather than an apportionment of total corporate income (that is used by many of the corporate net income tax states). However, should Washington voters choose to include corporate net income in the state tax base, the inability to apply consolidated corporate reporting for multi-national firms would then result in an adverse revenue impact for Washington.

Several attempts have been made to adopt a corporate net income tax in Washington, usually in conjunction with a reduction or elimination of the inequitable and regressive gross receipts tax. The inability to require consolidated reporting of the multi-national firms could seriously jeopardize future efforts at the polls to obtain a more equitable tax structure with the legitimate argument by local corporations that the large multi-national corporations may escape their proper share of state tax liability (by simply assigning profits to an affiliate in the United Kingdom or Mexican, Canadian, etc. firm *related* to a United Kingdom firm).

In summary, the State of Washington opposes ratification of the treaty in its present form and urges modification of the treaty language to take into account the concerns expressed herein.

STATE OF WEST VIRGINIA,
OFFICE OF THE GOVERNOR,
Charleston, July 7, 1977.

Hon. ROBERT C. BYRD,
U.S. Senate, Old Senate Building,
Washington, D.C.

DEAR SENATOR BYRD: The Senate Committee on Foreign Relations has scheduled hearings on July 19-20, 1977, on the proposed tax treaty between the United States and the United Kingdom as I am sure you are aware.

Please relate to your colleagues on that committee West Virginia's opposition to ratification of the treaty unless and until Article 2, Paragraph (2)(c) and Article 9, Paragraphs (4) and (5) are deleted. The treaty as proposed would

not only harm the revenue from the West Virginia corporation net income tax but would also be an incursion into our State's taxing power.

Your assistance in this matter will be appreciated.

Sincerely,

JOHN D. ROCKEFELLER IV.

STATE TAX DEPARTMENT
OF WEST VIRGINIA,
Charleston, April 12, 1976.

Hon. ROBERT C. BYRD,
U.S. Senate,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: From a Department of Treasury news release dated January 6, 1976, it appears that the United States has signed a new income tax treaty with the United Kingdom on December 31, 1975. That release also indicates that the Senate has yet to consent to ratification. I believe that certain provisions of that treaty could prove injurious to the taxing authority of the State of West Virginia.

The objectionable provisions are these:

Article 2, Paragraph (2)(c)—

"The existing taxes to which this Convention shall apply are: * * *

"(c) for this purpose of paragraph (4) of Article 9 (Associated Enterprises), taxes imposed on income by political subdivisions or local authorities of Contracting State."

and Article 9, Paragraphs (4) and (5)—

"(4) Except as specifically provided in this Article, in determining the tax liability of an enterprise doing business in a Contracting State, or in a political subdivision or local authority of a Contracting State, such Contracting State, political subdivision, or local authority shall not take into account the income, deductions, receipts, or outgoings of a related enterprise of the other Contracting State or of an enterprise of any third State related to an enterprise of the other Contracting State.

"(5) For the purposes of this Convention, an enterprise is related to another enterprise if either enterprise directly or indirectly controls the other, or if any third persons (related to each other or acting together) control both."

The proposed treaty has a much broader sweep than the 1946 treaty and the supplementary protocols of 1954 and 1966. The sections quoted above are undesirable because they preclude the States from requiring consolidated returns from associated enterprises. West Virginia Code § 11–24–13, relating to corporation net income tax, specifically allows the Tax Commissioner to require consolidated returns from affiliated corporations. When the income of the consolidated unit is reported, it is then apportioned so that the West Virginia taxable income can be ascertained. Should the treaty become effective, that section would become meaningless for those multinational corporations coming under the purview of the treaty. It seems likely that the treaty would encompass not only United Kingdom and United States corporations but also any multinational corporation, no matter where chartered, which is qualified to do business in both the United Kingdom and the United States.

It is difficult to determine the actual financial effect that the treaty would have on West Virginia. However, it is easy to see that the potential restriction is quite significant. Such a change regarding the qualifying corporations could have repercussions affecting our entire Corporation Net Income Tax structure. Further, once that authority is taken from the States, no amount of remedial legislation by the States could return it. Only withdrawal of the treaty could correct the situation. But still, the precedent would have been set.

For these reasons, I respectfully urge you to oppose ratification of this treaty unless and until the objectionable provisions specified above are deleted. I would be pleased if you would specify someone on your staff with whom I can communicate directly regarding this matter and ask that person to inform me of any action which is taken.

Sincerely,

RICHARD L. DAILEY,
State Tax Commissioner.

THE PLESSEY COMPANY LIMITED,
MILLBANK TOWER,
London, July 21, 1977.

Senator JOHN SPARKMAN,
Chairman, Committee on Foreign Relations,
Senate Office Building, Washington, D.C.

DEAR SENATOR SPARKMAN: I enclose herewith five copies of a Statement on behalf of The Plessey Company Limited and its American shareholders urging the ratification, without reservation, of the US/UK Double Taxation Treaty currently being considered by the Committee.

I would appreciate it if this Statement can be made part of the record of the hearings of the Committee.

Yours truly,

Enclosures.

WARREN J. SINSHEIMER.

PREPARED STATEMENT OF WARREN J. SINSHEIMER

I welcome this opportunity to present my views upon ratification of the Double Taxation Treaty between the United States and the United Kingdom.

In the interests of the many U.S. shareholders of The Plessey Company Limited ("Plessey"), of which I am Deputy Chief Executive, I favor ratification of the Treaty, without reservation, for the reasons discussed below.

I. GENERAL DISCUSSION

Plessey is a publicly-held United Kingdom corporation which manufactures and sells, throughout the world, telecommunications equipment, electronic equipments, systems and components, products for the aerospace industry and consumer audio products.

Plessey's business ties with the United States fall primarily into two categories.

First, Plessey has major subsidiaries which engage in manufacturing and sales activities in the United States. Those subsidiaries are domestic corporations which are, of course, fully subject to U. S. taxation—Federal, state and local.

Second, Plessey's Dollar Ordinary Shares, through the medium of American Depositary Receipts, are listed on the New York Stock Exchange and held by approximately 25,000 U. S. shareholders.

Thus, Plessey and the United States have, in a sense, invested in each other. Plessey is proud of its role in the American business community and gratified by the investment made in it by U.S. shareholders; and it quite naturally seeks to foster both the legitimate interests of its many U.S. shareholders and the maintenance of a business climate conducive to its continuing investment in the United States. In these objectives Plessey is, of course, not alone among U.K. corporations whose shares are traded in U.S. securities markets.

It is axiomatic that income taxes, despite their immense complexity, are of crucial importance in today's business world. Income tax considerations are, in fact, often determinative of the ability or willingness of any corporation—foreign or domestic—to follow a course otherwise commended by non-tax business considerations.

The relative importance of income tax considerations tends to increase many-fold, for both a corporation and its shareholders, when the corporation's business activities become subject to a multiplicity of taxing jurisdictions and taxing statutes.

The multiplicity of taxing jurisdictions will have the obvious effect of increasing the number of sources of impositions aganst the corporation and its shareholders. The multiplicity of applicable taxing statutes will typically compound the separate complexities of the taxing systems, because they will often differ from one another in structure and concept as well as in rates and other operational details. For a corporation or shareholder faced with multiple impositions upon the same items of income, amelioration of their effect tends to become (1) essential to economic survival, (2) sound, as a matter of tax policy, and (3) difficult of attainment—all at the same time.

A principal function of tax treaties is, of course, to lessen the frequency or impact of such multiple impositions. It is, in this context, a truism that each national party to such a treaty must usually, by making the treaty, yield at least some part of its sovereign jurisdiction to tax.

Plessey and its U.S. shareholders, though hardly alone in facing the problem of multiple impositions, urgently seek such mitigation of that problem as may equitably comport with sound considerations of U.S. tax policy. I respectfully urge that the Treaty would provide such relief on a sound, fair and deliberately considered basis. The Treaty has been in negotiation for several years, and its provisions would operate in a manner which would be both fair to the taxpayers involved and responsive to the legitimate needs of the affected taxing jurisdictions.

II. THE ADVANCE CORPORATION TAX

An important present problem dealt with in the Treaty is of particular concern to Plessey and its U.S. shareholders. In 1973, the United Kingdom restructured its income tax provisions applicable to U.K. corporations and their shareholders, by adopting an Advance Corporation Tax ("A.C.T.") measured by the payment of dividends. Although the A.C.T., at a rate of 35%, is imposed upon the U.K. corporation paying the dividends, a U.K. shareholder is entitled to apply this imposition against his personal income tax levied upon receipt of the dividend. On the other hand, U.S. and other nonresident shareholders of a U.K. corporation are not entitled to any correlative refund of the A.C.T. paid by reference to the dividends which they receive. Indeed, the plight of U.S. shareholders of such a U.K. corporation is aggravated by the fact that the A.C.T. is imposed upon the corporation, rather than upon them, which raised questions concerning whether the A.C.T. applicable to their dividends qualifies for a U.S. foreign tax credit and, if so, in what amount.

The foregoing summary of the adverse consequences of the A.C.T. for U.S. shareholders suggests the questions of whether the A.C.T. itself may not be the real "culprit", and whether the appropriate solution to U.S. shareholders' problems should perforce be sought through the medium of a double taxation treaty.

A relatively simplistic answer to these questions is that enactment of the A.C.T. represented, without question, a proper exercise by the U.K. of its jurisdiction to tax the income of U.K. corporations, and that the U.K. was under no legal or moral duty to formulate its tax provisions in such manner that they might more perfectly mesh with U.S. income tax provisions.

A further reason, independent of considerations of sovereignty, is that the A.C.T. represented a *bona fide* and reasonable attempt on the part of the U.K. to solve the problem of how to tax corporations and their shareholders, a weighty problem which has perennially perplexed governments, including our own. The A.C.T., in fact, embodies a significant degree of the very unification in the shareholder-corporate area which our President has recently suggested be seriously considered for enactment here.

Moreover, as pointed out by the State Department's Submittal Letter, a similar type of imputation system has been adopted by other members of the European Economic Community, and in the future will probably gain even further acceptance. Hence, the A.C.T. relief contained in Article 10 of the Treaty not only would ameliorate the A.C.T.-related problems of U.S. shareholders of U.K. corporations, but would also stand as a valuable precedent in the negotiation of double taxation treaties with other countries employing an imputation system in respect of corporate dividends.

III. ARTICLE 9(4) OF THE TREATY

No objection has been heard to acceptance of the A.C.T. relief provided by Article 10 of the Treaty. However, there appears to be strenuous objection to another provision of the Treaty which is well known to have constituted the principal inducement to the U.K.'s acceptance of the financially burdensome provisions of Article 10. That provision is Article 9(4), which would have the effect of precluding the computation of U.S. income taxes (Federal, state or local) on a combined, or "unitary", basis if there were arm's-length dealing between a U.K. parent and its U.S. subsidiaries and affiliates. Since our Federal income tax regimen does not require or even permit a unified computation in such circumstances, the principal effect of Article 9(4) would be upon those

few states which prescribe unitary combination with foreign parents and affiliates.

A "unitary" computation is premised upon relative levels of business activity rather than profits, and therefore will result in a tax which has no necessary correlation with the actual or economic profits of the corporation which is being taxed. If the profit rate of a foreign affiliate exceeds the profit rate of a corporation doing business in a state prescribing unitary apportionment, the effect is tantamount to the state's taxing the profits of the foreign enterprise. This has been expressly recognized by the Secretary of the Treasury, who has also stated that the internationally accepted arm's-length standard is not only more accurate but also far less arbitrary than unitary apportionment.

Without denigrating the authority of any state to impose a nondiscriminatory income tax upon income produced within its borders, the true effect of unitary apportionment is of such doubtful Constitutional validity that its spectre should not be permitted to jeopardize the substantial benefits to U.S. taxpayers generally which are provided for in Article 10 of the Treaty.

The imposition of unitary apportionment can obviously discourage new investment, and even the continuation of existing investment, by foreign corporations. For example, according to the Wall Street Journal (July 12, 1977, page 35), unitary apportionment is a principal reason for a Japanese auto manufacturer's failure to proceed with plans to construct a major plant in California.

Though our states are basically free to encourage or discourage new investment within their borders, the United States also has a sovereign interest in such matters. This is particularly true where one state's actions would adversely affect other states and their citizens; and in such a case the national interest should be considered as preempting that of the individual state.

It is public knowledge that a reservation by the Senate as to Article 9(4) would cause the U.K. to abandon at least the relief to be granted on its part under Article 10. An important reason given for this position—apart from the negotiating posture that one provision constituted the *quid pro quo* for the other—is the staggering compliance burden which unitary apportionment places upon a foreign enterprise, by requiring its own and its affiliates' income accounts to be restated, not only in terms of U.S. currency, but also in conformity with U.S. tax accounting principles. Such principles often vary greatly from the accounting principles actually used in conformity with the tax laws and other governing rules of the various foreign jurisdictions in which the business is carried on.

[From the Wall Street Journal, July 12, 1977]

BROWN DEFENDS STAND

Gov. Brown says the strategy of luring a Japanese auto plant is "good sound policy" on which both businessmen and environmentalists can agree. He says that Japanese autos are relatively nonpolluting and are energy savers, that California is a large market for Japanese cars, and that a new auto plant here would obviously create jobs for Californians.

The reaction in California has been mixed. The governor's trip, says Mr. Draine of Coldwell Banker, "was the first signal he was hearing our complaints." But the Republican leader of the state senate, George Deukmejian, calls the trip "just another staged public-relations gimmick."

The reaction in Japan has been noncommittal. The auto makers are reluctant to locate in California, primarily because the state is one of three (along with Oregon and Alaska) employing a unitary method of taxation on multinational companies' total operations. Simply stated, the unitary method uses a multinational's total net income as a basis for determining taxable income—against which California, for instance, applies a 9% corporate tax rate. The Japanese believe this method would overstate their potential tax liability in California. Gov. Brown says he is studying whether to recommend dropping this method of taxing multinationals.

On another important front, Gov. Brown and Assembly Speaker Leo McCarthy have proposed a bill that would, in effect, reduce the bureaucratic red tape involved in environmental regulation by setting an 18-month time limit for decisions to be rendered by various local and state authorities (there isn't any time limit now). Also, a single environmental-impact statement would be required, rather than separate ones for various state agencies.

THE SECRETARY OF THE TREASURY,
Washington, February 15, 1977.

Mr. MARTIN HUFF,
Executive Officer,
California Franchise Tax Board,
Sacramento, Calif.

DEAR MR. HUFF: Thank you for your letter of January 24, 1977 and the copy of your letter to Secretary Vance, concerning objections to paragraph 4 of Article 9 of the proposed income tax treaty with the United Kingdom.

I understand your concern over this provision, but I cannot agree, after careful review of the issue, that the provision should be withdrawn from Senate consideration. I support the objective of the provision and furthermore, I feel that the Senate should be given the opportunity to voice its opinion.

I am sure that the arguments in support of the provision are familiar to you, but I would like to summarize them briefly.

The scope of the provision is quite limited. It will restrict the ability of California to include foreign affiliated corporations of a corporation doing business in California, only when that corporation is controlled by a U.K. corporation (which is in turn controlled by British shareholders). I am aware, as you state in your letter, that this does provide limited preferential treatment for U.K. based multinational corporations. You must bear in mind, however, that a treaty is a negotiated document containing a number of concessions by both partners. In the pending treaty, the United Kingdom made very important concessions, particularly in the treatment of dividends paid to U.S. investors. We view the Article 9(4) provision as an appropriate quid-pro-quo for the concessions made by the United Kingdom.

The unitary apportionment system is inconsistent with accepted tax treaty policy which prohibits one country from taxing the business profits of an enterprise of the other unless that enterprise is engaged in business through a permanent establishment in the first country. Under unitary apportionment, if the profit rate of a foreign member of a unitary group exceeds the profit rate of the member doing business in California, the effect is tantamount to taxing the profits of the foreign enterprise.

Though you state that unitary apportionment is "the most accurate and reasonable method yet devised" for assessing the income of one element in a multinational group, it is our experience, as well as that of most other countries, that the determination of income on the basis of an arm's-length standard is not only more accurate but also far less arbitrary. The arm's-length standard is the internationally accepted approach. Thus, in an international context, the use of another method by one jurisdiction will often lead to double taxation.

The unitary system imposes a substantial compliance burden on multinational corporations. Much of the information required for a combined report with respect to a foreign parent or foreign sister corporation may not be available to the taxpayer. Even where the information is available, the burden of reporting the accounts of many far-flung affiliates on a standardized basis can be great. We are aware of cases where this burden has discouraged foreign investment in the United States.

For all of these reasons, I repeat, the provisions of the proposed income tax treaty with the United Kingdom seem to me wholly appropriate and desirable.

Sincerely yours,

W. MICHAEL BLUMENTHAL.

Submitted By: Committee on State Taxation, Council of State Chambers of Commerce.

Re Reasons Article 9(4) of the Pending Treaty with the United Kingdom Should be Ratified.

The Administration has submitted for ratification a new tax treaty with the United Kingdom which contains many provisions of critical importance to U.S. companies and their shareholders. The treaty has been carefully worked out by the Treasury over many years, has been strongly supported by two successive Administrations, and should be ratified as promptly as possible.

The Committee on State Taxation, which consists of approximately 100 U.S. companies, has actively been involved in the study of state taxation for many years. While these companies have a particular interest in Article 9(4), which

relates to state taxation, they are also vitally affected by Articles 10 and 23, which relate to the amount of tax they and other U.S. shareholders must pay to the United Kingdom and the computation of their foreign tax credit for Federal income tax purposes.

ARTICLE 9(4) RELATING TO STATE TAXATION

The Committee on State Taxation strongly supports Article 9(4), which relates to state and local income taxes imposed in the U.S. with respect to the income of U.K. companies.

The treaty precludes a state from extending its tax jurisdiction worldwide by use of the so-called "unitary formula." Under this formula, some states have attempted to make subsidiary corporations operating locally pay tax on the income of U.K. parent corporations which are themselves not doing business in the United States.

Article 9(4) should be ratified for the following reasons:

1. Application of the extraterritorial tax by any state is disruptive of international trade, discourages investment in the U.S., undermines the Treasury's negotiating position,[1] and invites retaliation by other countries against the U.S. companies operating there. (What would the U.S. reaction be if a local government in the U.K. taxed the income of General Motors from the sale of cars in Detroit merely because General Motors happened also to have a small subsidiary operating in the U.K.?)

2. The unitary formula is contrary both to the Federal tax system and to the general principles of international taxation adhered to by nearly all countries. It is also contrary to the Uniform Division of Income For Tax Purposes Act (UDITPA) long adhered to by nearly all the states for allocating and apportioning the U.S. source income of companies engaged in interstate commerce.

3. Application of the unitary formula produces totally unjustifiable results. An example, extracted from a survey conducted by the Committee on State Taxation, will suffice to illustrate:

A U.K. corporation owned and operated by U.K. citizens solely outside the U.S. bought a U.S. subsidiary in State A which at the time of the purchase was operating at a loss and therefore owed no tax to State A. The subsidiary continued to operate at a loss after the purchase of its stock by the U.K. parent corporation, but State A applied the unitary formula and taxed to the subsidiary part of the income of the U.K. parent corporation derived solely outside the U.S. and totally unrelated to State A. The "loss" subsidiary, thus, had to pay a large amount of tax to State A.

Article 9(4) would preclude this totally unjustifiable result. Clearly it is a necessary and reasonable limitation on extraterritorial taxation by states and should be ratified for those reasons alone.

ARTICLES 10 AND 23 RELATED TO ADVANCE CORPORATION TAX

There is another reason for prompt ratification of Article 9(4). It is probable that if the U.S. does not ratify Article 9(4), the United Kingdom will withdraw from the treaty, needlessly causing U.S. shareholders to lose the substantial benefits provided in Articles 10 and 23.

The United Kingdom, several other European countries, and Canada (the location of about 40 percent of U.S. foreign investments) have recently adopted integrated tax systems. Under these systems, when shareholders receive dividends, they are allowed a refundable tax credit equal to the tax already paid by the corporation on the earnings distributed. These countries have steadfastly refused to allow such a credit to U.S. or other "foreign" shareholders other than portfolio investors (*i.e.*, taxpayers owning less than 10 percent of a corporation's stock).[2]

Articles 10 and 23 of the U.K. treaty are a landmark exception to this position. They would for the first time extend the credit system to U.S. nonportfolio

[1] The extraterritorial taxation arising from the unitary formula is considered by other countries to be so contrary to their interests, that so long as it exists, they will demand other concessions from the U.S. in treaty and trade negotiations that will adversely affect U.S. companies operating abroad.

[2] Portfolio investors have been allowed the credit, but only by tax treaty.

investors. This is a major concession, and the U.K. treaty, if ratified, will be a significant precedent for similar negotiations between the U.S. and other countries.

A simple example illustrates how the new U.K. treaty would be much more favorable than the existing treaty, both to U.S. shareholders and to the U.S. Treasury. Assume a U.S. corporation owns all the stock of a U.K. subsidiary; the U.K. subsidiary has income of $100, on which a U.K. corporate tax of $52 is due; and the U.K. subsidiary distributes the remaining $48 to the U.S. shareholder.

Under the existing treaty, the U.K. allows the U.S. shareholder no credit for the U.K. corporate tax imposed on the subsidiary and, in addition, imposes a 15 percent withholding tax on the dividend. The U.S. shareholder ends up with cash in hand of $41, and, because the total effective rate of U.K. tax is higher than the 48 percent U.S. rate, pays no U.S. tax.

Under the new treaty, the U.K. would allow the U.S. shareholder a credit for a portion of the U.K. corporate tax imposed on the subsidiary, would impose only a 5 percent withholding tax, and would refund the excess of the credit over the withholding tax to the U.S. shareholder. The U.S. shareholder would end up with cash in hand of $58, of which $6 would be payable to the U.S. Treasury because the total effective rate of U.K. tax would be lower than 48 percent.

Thus, the new U.K. treaty would mean an additional $11 to the U.S. shareholder and $6 to the U.S. Treasury.

STATEMENT IN SUPPORT OF ARTICLE 9(4) OF CONVENTION BETWEEN THE UNITED STATES AND THE UNITED KINGDOM FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME

The following Statement has been prepared and is being distributed by Joanne M. Garvey, Cotton, Seligman and Ray, One Maritime Plaza, Suite 1400, San Francisco, CA., 94111, acting as agent of a foreign principal, i.e., Barclays Bank of California, 111 Pine Street, San Francisco, CA., 94111.

As required by 22 United States Code Section 611 et seq., Cotton, Seligman and Ray has filed with the Registration Section, Department of Justice, Washington, D.C., a Registration Statement as an agent of Barclays Bank of California. A copy of the Registration Statement is available for inspection at, and copies of this material are being filed with, the Department of Justice. Registration does not indicate approval by the United States Government of this material.

I. INTRODUCTION

This statement in support of the ratification of Article 9 of the proposed Tax Convention between the United States and the United Kingdom is submitted on behalf of Barclays Bank of California, a California state bank, doing business in the State of California. Barclays Bank of California is the wholly-owned subsidiary of Barclays Bank International Limited, which, in turn, is owned by Barclays Bank Limited, both of these being United Kingdom corporations.

Barclays Bank International has been involved in banking in the United States since 1890 when it opened an agency in New York. At present it has two wholly-owned subsidiaries, Barclays Bank of New York and Barclays Bank of California, doing business in the United States as chartered state banks, branches in New York, Boston and Chicago and agencies in San Francisco and Atlanta.

Article 9(4) of the Tax Convention between the United States and the United Kingdom limits the right of a Contracting State or a political subdivision or local authority of such State to take into account in determining the tax liability of an enterprise doing business within the State, the income, deductions, receipts or outgoings of any related enterprise which is a resident of the other Contracting State or an enterprise of a third state which is related to the enterprise of the other Contracting State, neither of which is doing business in the first State. The practical effect of this provision is to prohibit the inclusion by

the California state taxing authorities of the income of United Kingdom parent corporations and subsidiaries not doing business in California in the state income tax base of subsidiaries operating in California. To date California, Oregon and Alaska are the only states which are reported to apply the "unitary tax" method to include such income.[1]

The various Barclays affiliates will be directly affected by ratification of Article 9(4) of the Tax Convention. Barclays Bank of California and the San Francisco agency of Barclays Bank International have been assessed for additional California taxes for the years 1969 through 1972. In the tax base for purposes of determining California's share of the income to which its tax rate is applied is the worldwide income of Barclays Bank Limited, Barclays Bank International and all of their other affiliates not doing business in California. Ratification of Article 9 will not alleviate any tax liabilities for these earlier years, but such ratification will eliminate such inclusion in the future.

In making this presentation, however, Barclays is not seeking to avoid payment of its fair share of taxes. Other methods of taxation may, indeed, produce greater tax. Rather, Barclays believes that the unitary tax method creates such uncertainties and inequities in international commerce as to make this question uniquely one for consideration on a federal, not state, level and particularly suitable for settlement by treaty.

II. THE UNITARY BUSINESS TAX METHOD CREATES UNIQUE BURDENS FOR INTERNATIONAL BUSINESS

Corporations doing business across state lines already face problems in multistate taxation. As the court said in *U.S. Steel Corp.* v. *Multistate Tax Commission*, 417 F.Supp. 795 (S.D.N.Y. 1976), probable jurisdiction noted for appeal —— U.S. ——, 51 L.Ed.2d 533 (February 22, 1977):

Specifically, multistate taxation raises the risk of duplicative taxation, and the problem of proper allocation of tax bases among the several taxing jurisdictions, issues which do not arise where a business is subject to taxation in only one jurisdiction." [At page 805]

The difficulties and burdens increase in international business because the state tax systems are based on United States accounting and record keeping methods and on a relatively uniform economy. The federal income tax method, recognizing this, distinguishes between domestic and foreign source income and seeks to tax only the former.

State taxation, however, has proceeded in a different direction with most states using some form of formulary apportionment, including a variation known as the unitary business tax. This method, because of its complexity and need for record keeping and information, often extraneous to the business record system, increases compliance costs. Moreover, the states have not adopted one uniform method or even uniform interpretations, the failure to do so adding to the uncertainty and the compliance costs. These burdens are heavy for multistate businesses. International businesses, particularly those not based in the United States, and with different tax systems, different accounting methods and different record keeping requirements bear an even heavier burden when attempting to conform to state requirements.

A. State Tax Methods

No state purports to tax any income except that attributable to activities within its boundaries. However, the method of ascertaining this income will differ. One method is separate accounting which treats the activities of a taxpayer within and without the state as though these were separate businesses.

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[1] Only within the last eight years has the California Franchise Tax Board sought to include foreign subsidiaries of United States parents on the combined report, and within the last three to four years applied the concept to multicorporate groups with foreign parents. The inclusion of entities organized under the laws of foreign countries in a combined report has not yet been tested in the courts although there are several administrative decisions by the California State Board of Equalization upholding such inclusion with respect to foreign subsidiaries of a United States parent and one decision including a foreign parent of a United States subsidiary. See Petersen, "California Franchise Tax: Combined Income Report Affects Foreign Companies", 44 J. Taxation 184 (1976).

Article 9 would have no effect on this approach. A second is formulary apportionment [2] which is applied to "unitary" businesses.[3]

Under the formulary apportionment method, unitary business income is divided by means of an arbitrary mathematical formula to allocate share of such income to the taxing state. Most states use a formula containing three factors—usually property, payroll and sales—items which generally bear some relation to the production of income. All of the factors are given equal weight. Each factor consists of a fraction, the numerator of which is the dollar value of the factor in the state and the denominator of which is the dollar value of the factor worldwide. The three fractions are added together and then divided by three. The resulting fraction, usually expressed as a percentage, is applied to the net income (before taxes) of the unitary business. The result is considered the income to be taxed by the state. The definition of the unitary business is generally quite broad and will include not only divisions of a corporation but affiliated corporations engaged in the "business" so long as each affiliate is part of a controlled group. There are no clear guidelines for inclusion within the unitary group, and this threshold question of what constitutes the unitary business has resulted in constant litigation.[4]

B. The Burdens on International Business

1. Uncertainty

An enterprise seeking to do business in a geographic location will attempt to ascertain the costs of such business. Tax is one of such costs. However, the tax costs of the unitary business are extremely difficult to ascertain because these depend not on the profitability of the enterprise located within the state in question, but upon the profitability of what is determined to be the *unitary* enterprise. This threshold question, as mentioned in part A, can be very difficult. For example, must a corporation which operates a winery include in its unitary tax base the winery operations outside California if it sells wine under a differ-

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[2] Formulary apportionment is the basic method of determining a state's share of tax on business done within and without the state by applying an arbitrary formula to the net income of the entire business. Where the business sought to be taxed is carried on by two or more commonly owned entities, California and a few other jurisdictions require the filing of a "combined report" by these to determine the amount of income to which formulary apportionment is to be applied (and the factors used to derive the fraction). Combined reporting will thus include formulary apportionment.

[3] California uses two basic tests to determine if a business is unitary: the operation of the portion of the business done within the State is dependent upon or contributes to the operation of the business without the state, or there exist unities of ownership, operation and use. In practice, if the ownership test is met, the taxpayer must show that the other tests are *not* met.

[4] A typical statement of the law usually included in recent decisions of the California State Board of Equalization appears in *Appeal of Beecham, Inc.* (SBE, March 2, 1977):

"The California Supreme Court has announced two general tests for determining whether a business is unitary. In *Butler Bros.* v. *McColgan, supra*, the court held that the existence of a unitary business is definitely established by the existence of: (1) unity of ownership; (2) unity of operation; and (3) unity of use. Subsequently in *Edison California Stores, Inc.* v. *McColgan, supra*, the court held that a business is unitary when the operation of the business within California contributes to or is dependent upon the operation of the business outside the state. More recent cases have reaffirmed these tests. (See e.g., *Superior Oil Co.* v. *Franchise Tax Board*, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33] (1963); *Honolulu Oil Corp.* v. *Franchise Tax Board*, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 40] (1963); *RKO Teleradio Pictures* v. *Franchise Tax Board*, 246 Cal. App. 2d 812 [55 Cal. Rptr 299] (1966). *The California courts have yet to clearly delimit the unitary business concept*, except to state, 'It is only if [a foreign corporation's] business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately that the separate accounting method may properly be used.' (*Butler Bros.* v. *McColgan, supra*, 17 Cal. 2d at 667–668.)" (Emphasis added).

Some of the activities of commonly-owned taxpayers which evidence a unitary business in the eyes of the California Board of Equalization are set forth in *Appeal of Pup 'n' Taco Drive Up* (SBE, March 2, 1977):

"Since appellant owns a 52 percent interest in the Denver and Albuquerque partnerships, the unity of ownership requirement is satisfied. (See *Appeal of Signal Oil and Gas Co., etc.*, Cal. St. Bd. of Equal., Sept. 14, 1970). Unity of use is also present since appellant establishes overall policy for the business, as evidenced by the fact that the partnerships' managers are subject to dismissal for failure to follow appellant's instructions. (See *Chase Brass & Copper Co.* v. *Franchise Tax Bd.*, 10 Cal.App.3d 496, 504 [87 Cal. Rptr. 239] (1970).) Unity of operation is evidenced by the use of a single trade name and system of operation, similar architectural styles and menus, common purchasing of distinctive spices, and the use of appellant's accounting firm to conduct periodic audits of the partnerships. Moreover, appellant leased property for the partnerships, offered them interest-free loans, and arranged for and guaranteed lines of credit. The infusion of capital, knowledge and business reputation into the partnerships presumably contributed greatly to their success."

ent label and perhaps even in competition with its California label? If it also has a perfume business, must it include in the unitary business the perfume operations which may be much more profitable? In California it is highly probable that the entire business will be classified as unitary, even if the businesses are operated in separate corporate entities, so long as the members of the boards of directors are the same, or the perfume operation engages in intercorporate activities with the winery operation such as the lending of money to the winery subsidiary at interest rates comparable to those at which the winery could borrow at a local bank.

What then does this enterprise face if it is classified as unitary? To determine its California tax it will ordinarily have to compile information on the property, payroll and sales of the entire business, within and without California. Assuming that these records are readily available (and, as will hereafter be discussed, the California definition of what is to be included in the property, payroll and sales factors may differ from the information which the business records for its own business purposes), a business must determine what proportion its California factors bear to the aggregate factors and apply that fraction to its unitary net income. The fact that the new winery in California is not a profit-making operation and is not likely to be a profit-making operation for many years makes no difference.

A winery will initially be a capital intensive business with large investments in vineyards and machinery for the production of wine. California is a high cost area. The business will find that the greater its investment in California, the more the factors will weigh in allocating income to California. The discrepancy between what it costs to do business in California and what it costs to do business outside is ignored: all businesses are presumed to be equally profitable. Again, this is a more or less valid assumption in a relatively uniform economy where the relation of cost to profit is uniform—that is, low cost areas will generate a lower profit than high cost areas. This is not true in an international context, particularly in developing nations, and it can become even more distorted where differing types of businesses with differing profit margins are included.

As a result, international businesses cannot really ascertain their tax costs in advance with any certainty under the unitary method but nevertheless must face the unpleasant fact that they will be paying a state tax even if their new business is not profitable.

2. Compliance Costs

In addition to the burdens of uncertainty, compliance costs under the unitary tax method increase for international businesses. As mentioned earlier, the information requested is based on United States accounting and record keeping methods. For example, the California unitary payroll factor is based on compensation and fringe benefits which would be taxable under the Federal Internal Revenue Code to a person who is an employee as defined in the Federal Insurance Contributions Act. What does this mean to a foreign enterprise? Elsewhere in the world wages paid often include such fringe benefits as housing or insurance which might not be included in the payroll factor of a United States employer. Must all payroll records be recomputed to conform to United States methods? Similarly, in the property factor, property must be accounted for by using original cost basis for tangible real and personal property, eight times the net annual rental value for rented real and tangible personal property, and the adjusted federal income tax basis for intangible personal property (such as securities). This information as to assets outside the United States may not be available, or may not be kept, or may be kept in a different fashion by an international business.

In short, the unitary tax method requires international businesses either to shift fully to United States record keeping methods for all operations—which may not be practical in terms of the demands of their own countries—or keep an additional set (or sets—see subpart 4 hereafter) solely for state tax compliance. International businesses may not choose to do this for small subsidiaries.

3. The Unitary Tax Method Designed Only for the United States Economic System

The application of the unitary tax method to international businesses produces distortion and discrimination. The method is designed with a relatively

uniform free trade area in mind, namely the United States. Although profitability and cost may differ in different parts of the Unted States, the competitive conditions do not differ substantially and decisions as to prices and markets are generally made on the basis of competitive concerns. There is one nationwide monetary system.

Outside the United States these conditions do not necessarily obtain. Each dollar of property, payroll and sales does not contribute more or less uniformly to each dollar of profit. In fact, the relative relationship between the factors and profits outside the United States is quite different than within the United States. The market economics may also be quite different.

For example, banking in the United States is a labor intensive industry and the United States is a high wage cost area. Outside the United States, wage rates will differ considerably (generally clerical workers who make up the bulk of a bank's staff are generally less well paid). On the profit side, however, interest rates in the United States are highly regulated, both as to those charged and those paid on deposits. But interest rates charged outside the United States, particularly in less developed countries, often tend to be substantially higher. Those banks in countries outside the United States where interest rates charged are lower generally pay less interest on their deposits with a resulting greater profit margin. As a result, costs in the United States are likely to be higher, but profit is likely to be lower. However, outside the United States costs are likely to be lower and profit higher.[5] Thus, rather than a relative relationship between factors and income within and without the United States, the unitary tax method produces the opposite result.

The effect of the foregoing is to allocate more income to the taxing state although such allocation bears little relationship to the activities of the business within the state. For example, during the years for which it has been assessed (1969–1972) Barclays Bank of California's tax assessment runs the gamut from a low of 15% of its net taxable income in California (1969) to a high of 97.5% (1972). The California tax rate was 11% in 1969 and 11.45% in 1972. The relative profitability of the California bank has little to do with the tax which depends in large measure on the profitability of Barclays' worldwide operations. For example, in 1972 the net taxable income earned by Barclays Bank of California represented less than .01% of the worldwide income, but California taxing authorities apportioned 1.160% to California (a 100% increase). The effect was an almost 100% tax (97.5%) of the entire net taxable income earned in California.

Much of the worldwide Barclays' profit comes from other types of businesses in which banks may engage outside the United States but not within the United States.

The unitary tax system also takes no cognizance of the economic effect of foreign exchange fluctuations. Since the concept of taxable income is based on an annual accounting period, a United States income tax concept, a foreign business must convert its net income before taxes into United States dollars as of a date (California permits month-end conversions for fluctuating currencies). This may create paper profit which does not reflect any true economic profit. Moreover, the mechanics of making various conversions is another added compliance cost.

Finally, because a state may not tax an entity which has no "nexus" (a sufficient presence or relationship with the taxing state), the taxing state alleges that only the entity doing business within the state is the taxpayer. The combined return used by the State of California, requiring filing by all the entities in the unitary business, is essentially an information return. However, the state has no jurisdiction over entities where there is no nexus and it looks to the taxpayer entity for any information about any part of the unitary business. Often the information requested would not ordinarily be supplied by a parent corporation to its subsidiaries. For example, one of the questions asked in the audit of Barclays Bank of California was what percentage of revenues of Barclays Bank Limited, Barclays Bank International, and Barclays Bank of California came from offering services to common customers of either or both of the other two corporations (a common customer being one for which Barclays Bank Limited, for example, performed services in England and Barclays Bank of California performed services for the United States branch of the customer).

[5] This cannot have escaped United States banks in view of the growth of international banking by domestic banks. See Part III A–1.

This information is not available to Barclays Bank of California and would not ordinarily be provided to it, for competitive and other reasons, by the parent. The Franchise Tax Board also asked for the names of all common customers, highly sensitive competitive business information and possibly an invasion of the right to privacy of those customers.

The undersigned has seen in other audits questions asked of a taxpayer about the business reasons for various decisions made by a parent company, again sensitive business information ordinarily not made available to subsidiaries. Refusal to answer such questions may lead to arbitrary assessment of the taxpayer subsidiary.

Accordingly, a foreign parent is faced with an internal business decision as to whether to supply such information. In addition, much of the information requested does not exist in the form requested or may not be readily obtainable and the foreign parent must make a further decision as to whether it will incur the cost of compiling or seeking this out.

In short, the unitary business tax grew up within the ambits of the United States, both practically and economically. Its extension beyond national borders creates compliance costs of uncertain magnitudes because the administrative problems created by this have not been fully ascertained: only in recent years has California sought to include foreign parents and affiliates within the method. And because distortion as an argument has been rejected within our United States economy, and because the burden is always on the taxpayer, there is no guarantee that courts or administrative agencies will even consider the obvious distortions and burdens which arise once outside the United States economic system. In fact, the California taxing authorities have stated administratively that they have no discretion to consider distortion in the factors of an individual taxpayer since this would amount to a consideration of "separate accounting."

4. Lack of Uniformity in State Tax Systems

Many of the states have recognized the problems in the lack of uniform state taxing systems. An attempt to achieve such uniformity has been made through the Multistate Tax Compact and the adoption of the Uniform Division of Income for Tax Purposes Act (UDIPTA) by many states. This approach at self-regulation has not been overly successful since only 23 states have become members of the Compact, with Illinois having withdrawn and California having become a member with certain restrictions. In all, 26 states have adopted UDIPTA.[6] Even the enactment of UDIPTA is deceptive; member states are not bound to interpret the Act uniformly.[7]

The burden from this confusion falls heavily on enterprises doing an international business. The information and record keeping requirements will differ from state to state, the question of which businesses are to be included will differ from state to state and even the factors will differ.[8] Multistate businesses face the same problems, but the compliance costs are not escalated by the need to change basic accounting and record keeping procedures or develop additional ones, the need to translate books and records or the need to deal with more than one monetary system.

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[6] Various authorities list different numbers of states which have adopted UDIPTA. See discussion of this in Boren, *supra*, footnote 2, at p. 993.

[7] The California State Board of Equalization, the administrative board which hears protests of taxes assessed by the Franchise Tax Board, recently rejected the decisions of Kansas and New Mexico courts in interpreting the meaning of "business income under UDIPTA." The Board pointed out that these courts did not consider that the Uniform Act's definition of "business income" was derived from prior California law nor did the courts examine the uniform regulations. *Appeal of Borden, Inc.* (SBE, February 3, 1977).

[8] For example, in computing the property factor:

(1) Migratory property is allocated on the basis of "time spent in state" in 15 states, but on the basis of mileage in 7 states.

(2) Goods in transit are included in the numerator for the destination state in 14 states, but excluded from numerator and denominator in 4 states. Wisconsin treats them as if they had already arrived at their destination.

(3) Rented tangible personal property is valued at 8 times annual rent in 35 states but totally excluded in 5 states.

(4) Rented realty is valued at 8 times annual rent in 38 states, valued at 7½ times annual rent in Minnesota, and ignored in 4 states. In Connecticut the unamortized value of the leasehold is excluded. Minnesota only includes property both rented and used in-state. Ohio counts only property used in-state in the numerator.

(5) Ohio and Kentucky exclude in-state pollution control facilities. 25 states exclude property if income is otherwise allocated. 20 states include such property. Iowa and Missouri ignore the property factor altogether.

Moreover, with several major commercial states, including New York, outside the Multistate Tax Compact and suing different tax bases, and with the new federal policy of denying deduction of state taxes based on foreign source income (see part III A-3 hereafter), companies doing international business face the possibility of paying more than 100% of their income in federal and state taxes.

III. THE PROBLEMS CREATED BY THE UNITARY METHOD ARE PARTICULARLY SUITED FOR SETTLEMENT BY TREATY

A. The Tax Barrier is a Matter of Federal Concern

Taxation is always part of the economic cost of doing business. Where there are added to the basic tax burgeoning costs of compliance and where businesses face policy decisions potentially disruptive to internal operations, the costs, both real and psychological, may become too great. At that point, the tax constitutes a barrier to investment which, unlike the decision made by a domestic corporation not to locate in a particular state, may result in overall loss to the United States economy: a domestic corporation determining not to locate in one state will presumably locate in another; a foreign business may not come to the United States at all.

1. International Businesses, and Particularly International Banking, Are Important to the Federal Economy

Since this presentation is on behalf of banks, we will confine our remarks to the role of banking within and without our economy. We believe, however, that our remarks would be appropriate as to many other multinational businesses, both United States and foreign owned.

Multinational banking has expanded rapidly both within and without the United States. In the last decade United States banks have taken the lead in developing global banking networks. For example, as of December 31, 1976, 245 United States banks had active international departments and of these 151 had some type of representation in one or more foreign countries.[9]

Similarly, foreign banking in the United States has expanded. A 1975 Department of Commerce Report, part of a broad foreign investment study mandated by the Foreign Investment Study Act of 1974, stated that between 1965 and 1975 the assets of foreign banks in the United States jumped from seven billion dollars to fifty-seven billion dollars.

The 1975 Report [10] stated that the effect of foreign owned banks on the United States economy was difficult to ascertain. It concluded:

"However, it seems likely that they do bring additional resources (funds, skills, ideas and energy) into the United States and therefore stimulate the domestic economy to some—perhaps minor—extent. Such stimulus is likely to be felt mainly in certain economic sectors, *e.g.* export industries, U.S. affiliates of foreign multinational enterprises, foreign exchange operations, and the money market." [At p. A-10.]

A more important finding of the study was the reciprocal effect of foreign banking operations on United States banking operations abroad:

"Many nations, including the United States, do not allow foreign banks to operate within their borders unless the home countries of those banks give reciprocal treatment (however that may be defined) to their own banks. Hence, permitting foreign banks to operate in the United States has kept open the doors of most other countries for U.S. banks wanting to operate abroad. These overseas operations of U.S. banks are important both to them and to the United States. Their earnings are large, and repatriation of such earnings benefits the U.S. balance of payments. They finance and promote U.S. exports, provide important services to U.S. travellers, businessmen and government officials, send back information about economic and financial conditions in other countries, and increase U.S. influence around the world. They also contribute much to countries in which they operate by channeling to them funds, skills and ideas. Moreover, international banking is a major force helping to bind together the free world and making for international cooperation. It is, however, a multi-

[9] Tenth Annual Survey of International Activities of United States Banks, American Banker, February 22, 1977.

[10] As summarized in the Washington Financial Reports, November 3, 1975, pages A–7–A–11. All page citations to quotations from the Report are to the foregoing summary.

directional system that can continue to function only if the principal nations, including the United States, keep open their doors to each other's banks." [At p. A-10.]

Similarly, a study done by the Superintendent of Banks in the State of California (Report on Foreign Banking Matters of the Superintendent of Banks, April 1974) found that continued expansion of such foreign owned or controlled state chartered banks in the State of California, subject to impartial regulatory restraints, was in the public interest and did not injure the viability of any sector of the state's banking industries as presently constituted. The report pointed out to a very significant degree foreign receptivity to California-based banks had been predicated on California's own open attitude toward foreign bankers:

"On the whole the international exchange of banking services has been to California's net advantage as is adequately demonstrated by profit results (*Cf.*, Milton Moskowitz, *San Francisco Chronicle*, March 16, 1974) and by daily news accounts of California-based banks increasing or proposing to increase their foreign investment. Any restriction which choked off such interchange could be expected to reduce California's gain from it. Conversely any change which encourages it would be to the State's advantage. Secondly, such restrictions would diminish the saleability of current investments in bank ownerships by eliminating a class of potential purchasers." [At p. 61.]

Other advantages from foreign banking which the Superintendent found were the increases in the availability of banking services to consumers in developing areas of the state, the maximization of consumer choices as to the source of those services, and the multiplier effect of bank investment, as well as other investment, on economic activity.

In short, banking, whether conducted by United States owned banks or by foreign owned banks, has expanded beyond national boundaries. Domestic banking, long highly regulated by the federal government, is no longer localized and those areas of the economy where the stimulus of international banking activity is most likely to be felt, such as expert industries and foreign exchange operations, are often also regulated by statute or treaty.

The same can be said of other types of businesses which cross national boundaries and whose activities are regulated by federal law or by existing treaty in numerous areas. These are matters of federal concern and federal policy. They involve relationships between nations, not among the states and not between the states and the federal government. The single strand of state and local taxation should not be pulled from the fabric of modern international economics and commerce lest it unravel the whole.

2. State Taxation of International Business Cannot Be Resolved at the State Level

There is a point at which state taxation becomes a matter of federal concern. For example, in *Scandinavian Airline Systems, Inc.* v. *County of Los Angeles*, 56 Cal.2d 11, 363 P.2d 25 (1961), the California Supreme Court decided that Los Angeles County should not be allowed to apply its apportioned property tax to SAS planes landing at Los Angeles International Airport because the matter had taken on a federal scope:

"When such a vehicle becomes an instrument of communication with foreign nations it is apparent that the apportioned basis of taxation is unworkable because the courts of this country can exercise no control of the foreign taxing authorities. The matter then should become an exclusively federal one. To this extent we agree partially with the appellants herein who state in their briefs on file that: 'State taxation of the planes of foreign air carriers involves international political and economic problems which the courts are incapable of satisfactorily resolving. Decision of whether the states should have the power to tax planes of foreign air carriers engaged in foreign commerce should be left exclusively with the executive and legislative branches of the federal government.'" [At pp. 32–33.]

Moreover, the states have neither the means nor the authority to deal with problems of international business. The state courts are loath to face such questions:

"Thus the threat of double taxation from foreign taxing authorities has no role in commerce clause considerations of multiple burdens. Indeed, it is gratuitous to suggest that a state is alleviating any threat of multiple burdens by

limiting its own taxing power, when foreign nations may tax instrumentalities of commerce that touch their jurisdiction at any rate they choose. The commerce clause mandates apportionment among the several states in order to avoid discriminatory burdens on interstate or foreign commerce. But apportionment among nations is a matter for international agreement; it should not be considered as a limitation on a state's power to tax." [*Sea-Land Service, Inc.* v. *County of Alameda*, 12 Cal.3d 772, 788, 528 P.2d 56, (1974).]

Again, in *Scandinavian Airlines Systems, Inc., supra*, limiting discriminatory *local* taxes, in part because of the existence of a Swedish treaty, the court stated:

"The principles of state sovereignty apply to internal matters, only. No state of this union is sovereign in the eyes of a foreign nation. A state cannot deal directly with a foreign nation, by treaty or otherwise. This it must leave to the federal government. If its attempted actions in a given field would result in discriminatory practices as between two foreign nations, then it must eschew that field in its entirety. This is but another way of saying, as we said above, that taxation of foreign owned and based instruments of commerce represents a field that is peculiarly federal in nature, without regard to such specific constitutional considerations as the commerce clause or the due process clause, and which must be left to the administration of the federal government, even in the absence of any present federal legislation thereon." [At pp. 41–42.]

The State of California's use of the unitary business tax has *international effect:* recent newspaper reports state that the Governor's office is reviewing this method of taxation in an effort to encourage Japanese auto manufacturers to locate plants in California.[11] Is this ad hoc approach the best method of dealing with matters which admittedly extend beyond national boundaries? The scope is truly international, not limited to one state's prerogatives. The effect of any decision is a national one which should be made at the national level.

3. Federal Policy Is Preempting the Field of Taxation

There is already federal legislation and hence federal policy in the area of state taxation of foreign business. Internal Revenue Code Regulation Section 1.861–8(e)(6), and, most particularly Example 25 under Regulation Section 1.861–8(g), would deny deduction to a business for state taxes based on formula apportionments which include foreign-source income in the tax base.

Normally, state income taxes are deductible by the business paying such taxes (see Section 164 of the Internal Revenue Code of 1954). The states have long contended that state taxes based on formula apportionment determine only the income attributable to the state, not income earned outside the state. However, even the most ardent supporters of formula apportionment will concede that the method of determining state source income is not exact, and in fact may be distortive, the answer always being that "rough approximation rather than precision is sufficient." [12]

Nevertheless, Section 864 of the Internal Revenue Code requires the determination of the amounts of income from sources within and without the United States and permits deductions of state taxes paid in the United States only against income which has its sources in the United States. This is a policy determined by Congress by its enactment of this section. In interpreting Congressional policy, the Internal Revenue Service by promulgation of the two regulations cited above has determined that Congressional policy cannot be carried out unless the amount of the deductible state income taxes is limited to the income base permitted under the Internal Revenue Code section.

4. The Amounts Are Sufficient for Concern

Nor is the amount of tax so minimal that it can be ignored. Other presentations to this Committee refer to the probable amounts of tax affected by adoption of Article 9, and although the net estimates are relatively small (fifteen to twenty million dollars—unless the Committee accepts various amounts estimated by California as lost revenues which range from one hundred and fifty million dollars to five hundred million dollars) in relation to the overall California budget and revenues, they are not *de minimis* to those who must pay them.

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[11] E.g., see "Brown Rethinking Tax on World Firms", San Francisco Examiner, June 16, 1977 at p. 60.

[12] See e.g., *International Harvester* v. *Evatt*, 329 US 416 at 422, 91 L.Ed. 390 at 395 (1946); *John Deere Plow Co.* v. *Franchise Tax Board*, 38 Cal.2d 214, 238 P.2d 569 (1951).

B. Use of Treaty Limits Impact on the States

The solution by treaty to competing state and federal policies is particularly appropriate because it limits the solution to foreign commerce and it does not interfere with the states' rights to tax domestic commerce (which includes commerce done in the United States by foreign nationals) and to select their own method of so taxing. Moreover, since the states have been unable to agree on any uniform method of taxation, Congress, by ratifying the treaty, does not have to solve on a domestic level the problems arising from such lack of uniformity.[13]

In addition, the number of states which will be affected by adoption of Article 9 is unclear. Forty-four states use some method of formula apportionment, but the variations in these methods make the true impact of Article 9 on present or future state practices difficult to ascertain.[14] Only California, Oregon and Alaska have, at present, included in the tax base the income of foreign parents and affiliates not doing business with or in the state.

Article 9 does not eliminate formulary apportionment. What it does is eliminate the income of foreign-related enterprises which do not do business in the United States from the tax base and their property, payroll and sales factors from the numerator and denominator of the fractions. Accordingly, a California subsidiary, owned by a foreign parent which did not do business in California or in the United States, would report for purposes of formulary apportionment in California only its own net taxable income and only its own factors. However, if the California subsidiary did business in more than one state or if the foreign corporation owned other United States subsidiaries, all of these could be combined in determining net taxable income and a proper allocation of factors. This would then correspond with the foreign parent's treatment of its liability for federal tax. Article 9 would leave the states free to continue their own variations in applying formula apportionment to multistate operations.

Undoubtedly, the tax administrators of the various states will make known to the Committee the impact of this approach on their revenues. However, it is suggested that these are projections rather than losses since the decision to include income of foreign parents is a relatively recent one, and subject, in California at least, to protest of most of these assessments.[15]

Against the claims of the states must be placed the very real problems created by this method of taxation which, while theoretically fair, depends upon uniformity of interpretation and administration to reach the accomplished result and more importantly depends upon a uniform economy and uniform reporting methods to achieve the balancing to make this method truly fair. Multinational businesses, and more particularly foreign-owned multinational businesses, encounter unique problems from this method of taxation which are magnified as the businesses cross international boundaries.

C. Ample Precedent for Treaty

There is precedent for treatment by treaty of more than federal taxes. See *e.g., Scandinavian Airlines Systems* case, *supra*, in which the Swedish tax treaty limited the application of *local property taxes*. In addition, tax treaties presently in force with 18 nations have antidiscrimination provisions which apply to state and local taxes.[16]

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[13] These problems have been detailed in several studies and articles. See e.g., Report of the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, *State Taxation of Interstate Commerce*, H.R. Rep. No. 1480, 88 Cong. 2d Sess. 157–249 (1964) (hereafer the "Willis Subcommittee Report"); Hellerstein, "Current Issues in Multistate Taxation of Banks", 30 Tax L. Rev. 155 (1975).

[14] For a discussion of some of the variations see Boren, "Equitable Apportionment: Administrative Discretion and Uniformity in the Division of Corporate Income for State Tax Purposes", 49 So. Cal. L.R. 991 (1976); Willis Subcommittee Report.

[15] See Petersen, *supra*, footnote 1.

[16] The eighteen countries are: Austria, Belgium, Denmark, Finland, France, Germany (Fed. Rep.), Greece, Iceland, Luxembourg, Japan, Netherlands, Norway, Poland, Romania, Switzerland, Trinidad & Tobago, USSR, and United Kingdom (present treaty).

The provision of Article XXV(3) of the treaty with Netherlands is typical:

"(3) The citizens or subjects of one of the Contracting States shall not, while resident in the other Contracting State, be subjected therein to other or more burdensome taxes than are the citizens or subjects of such other Contracting State residing in its territory. The term 'citizens' or 'subjects' as used in this Article includes all legal persons, partnerships and associations deriving their status from, or created or organized under the laws in force in, the respective Contracting States. In this Article the word 'taxes' means taxes of every kind or description whether national, federal, state, provincial or municipal."

The present treaty with the United Kingdom also covers eight former colonies, now independent nations: Barbados, Jamaica, Malawi, Nigeria, Seychelles, Sierra Leone, Southern Rhodesia, and Zambia.

Treaties with such provisions have been signed but not ratified with four countries: Brazil, Korea, Phillipines, and Thailand.

Moreover, many treaties have dealt with what would ordinarily be thought to be matters of state concern, not federal concern. A case on point is inheritance rights which have long been regulated by treaty although inheritance rights are generally determined by state, not federal, rules. See *e.g., Kolovrat* v. *Oregon*, 366 U.S. 187, 6 L.Ed.2d 218 (1961).

D. Courts Cannot Deal with the Problems

Other presentations may deal with the potential unconstitutionality of this method of taxation when applied to foreign business. Indeed, this may be true, but the questions which are raised are those with which courts admit they cannot adequately deal and which are expensive of solution because of the delays and processes through which a decision of this sort must wind. A solution by treaty, highly visible to the foreign community, is a simpler and cleaner method to accomplish the same result.

E. The States Cannot Solve the Problems

The California Franchise Tax Board recently held a hearing[17] to receive suggestions for administrative procedures to meet many of the problems raised in this presentation. It was pointed out to the Board that most of its proposals for administrative action were either contrary to decided case law or were contrary to positions it was taking in litigation, such as lack of discretion to consider distortion or grant any special relief to individual taxpayers. The lack of unformity among the states in their own administrative approaches cries out for federal solution.

IV. CONCLUSION

The making of any treaty or any law is, of necessity, a balancing of interests. Article 9 represents such a balancing. The states always have interest in preserving their tax prerogatives, but these are not unlimited. Balanced against this is the enhancement of the economy through increased foreign investment with more jobs, and hence more revenues, for the states. The state of the economy has always had more impact on state revenues than a state's taxing system. That the unitary tax method by its lack of uniformity in application and administration has created problems of fairness has long been apparent. That this method of taxation has become a question of federal concern is also apparent, and where the burden falls unequally and unfairly on foreign commerce, efforts to equalize the burden should be made at the federal level. Article 9 of the Tax Convention should be adopted.

STATEMENT TO THE SENATE COMMITTEE ON FOREIGN RELATIONS BY THE EMERGENCY COMMITTEE FOR AMERICAN TRADE IN SUPPORT OF THE UNITED STATES-UNITED KINGDOM INCOME TAX TREATY

The Emergency Committee for American Trade (ECAT) urges Senate ratification of the United States-United Kingdom tax treaty presently before the Senate Committee on Foreign Relations. The treaty contains important benefits for American firms doing business in the United Kingdom and is an important up-date of the present 32-year-old US-UK tax treaty.

ECAT is an organization of the heads of 65 large firms with extensive overseas business operations. A list of members is attached. ECAT is devoted to the support of expansionary foreign trade and investment policies. A major interest is the taxation of foreign source income.

Of particular concern to ECAT member companies are two provisions of the tax treaty. They are Article 9(4) which restricts the ability of states under a unitary system to tax the non-U.S. income of British-owned companies, including their subsidiaries in the United States, and Article 10 which provides for a refund of a portion of the U.K. corporate tax to U.S. shareholders of British companies. We strongly support both provisions. They are directly related to each other. Disapproval of one would lead to disapproval of the other.

California and Oregon are the two states consistently using the unitary system of taxation whereby the state, pursuant to an apportionment formula,

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[17] July 12, 1977.

imposes a tax on business income earned within the state as well as on the income earned anywhere else by the corporation's affiliates. The practical difference between the California-Oregon unitary method and that practiced by most other states is that the unitary method sweeps foreign income into the state tax base. The unitary system is different from that of the Federal government which, together with most other countries, uses a standard whereby one country does not tax the profits of foreign business enterprises unless they are engaged in business in its territory. The unitary method goes well beyond this established federal and international practice. Imagine, for example, how the United States would react to one or more of the federal states of West Germany levying a tax on the U.S. income of American corporations happening to do business in West Germany.

As already noted, ECAT supports Article 9(4) of the treaty and its sensible restriction on the ability of states using the unitary method to tax the income of United Kingdom companies that is not earned in the states themselves. While approval of this article would pertain only to United Kingdom corporations, it would make clear the principle that state tax laws must conform to federal standards and not reach beyond them. This indeed was the basic recommendation concerning state taxation of foreign source income in the March 8, 1977, report of the Task Force on Foreign Source Income of the House Committee on Ways and Means.

Secretary of the Treasury, W. Michael Blumenthal, made the same point in a recent letter to Martin Huff, Executive Officer of the California Franchise Tax Board, when he said: "The unitary apportionment system is inconsistent with accepted tax treaty policy which prohibits one country from taxing the business profits of an enterprise of the other unless that enterprise is engaged in business through a permanent establishment in the first country."

A further reason for approving Article 9(4) is that the unitary method by levying a proportional tax on foreign income is an absolute disincentive for British and other foreigners to invest in the United States. A major purpose of tax treaties is to eliminate tax distortions that discourage investment.

Closely related to Article 9(4) is Article 10, which, as noted above, would refund a portion of the U.K. corporate tax to United States shareholders of British companies. This is a very major concession to the United States and is the quid-pro-quo for the provisions concerning the unitary tax system.

Some years ago the British partially integrated their income tax in order to avoid double taxation of corporate dividends. The British government now refunds to British shareholders of British corporations the corporate tax paid on the income distributed to the shareholders. The refund, however, does not extend to United States parents of British subsidiaries. As a matter of fact, no country utilizing a similar system of income tax integration extends the benefits of such integration to U.S. parent corporations. France, West Germany and Canada have such systems. This places U.S. subsidiaries in a disadvantageous position vis-a-vis their competitors in these countries. U.S. negotiators are seeking from them the same provision as is in Article 10 of the U.K. treaty, which makes even more pivotal the ratification of the U.S.-U.K. treaty. With it as a precedent, the chances for success in other tax treaty negotiations would be considerably enhanced and another impediment to international economic cooperation removed.

It has been estimated that the net effect of refunding the U.K. corporate tax to the U.S. parent would be to reduce the U.K. rate of tax from 52% to as low as 42%, depending on the degree of dividend payout. There would thus be an additional flow of many millions of dollars, perhaps as high as hundreds of millions of dollars, into the U.S. economy, a part of which would flow to the U.S. Treasury since the U.S. parent would pay federal income tax on the difference between the 42% U.K. rate and the 48% U.S. rate.

There are other desirable features of the U.S.-U.K. tax treaty. We strongly recommend its ratification.

MEMBERSHIP OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. Edward J. Ledder, Chairman and Chief Executive Officer, Abbott Laboratories.

Mr. David C. Scott, Chairman, Chief Executive Officer and President, Allis-Chalmers Corp.

Mr. Ian MacGregor, Chairman and Chief Executive Officer, AMAX Inc.
Mr. William A. Marquard, President and Chief Executive Officer, American Standard Inc.
Mr. Rodney C. Gott, Chairman and Chief Executive Officer, AMF Inc.
Mr. David W. Mitchell, President and Chief Executive Officer, Avon Products, Inc.
Mr. A. W. Clausen, President, Bank of America, N.T. & S.A.
Mr. William M Agee, Chairman and Chief Executive Officer, The Bendix Corp.
Mr. T. A. Wilson, Chairman and Chief Executive Officer, The Boeing Co.
Mr. James F. Bere, Chairman and Chief Executive Officer, Borg-Warner Corp.
Mr. Richard L. Gelb, President and Chief Executive Officer, Bristol-Myers Co.
Mr. Ray W. Macdonald, Chairman of the Board and Chief Executive Officer, Burroughs Corp.
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Mr. Walter B. Wriston, Chairman, Citibank.
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Mr. James McKee, President and Chief Executive Officer, CPC International Inc.
Mr. C. R. Dahl, President and Chief Executive Officer, Crown Zellerbach Corp.
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Mr. Justin Dart, Chairman and Chief Executive Officer, Dart Industries Inc.
Mr. William A. Hewitt, Chairman and Chief Executive Officer, Deere & Co.
Mr. John V. James, Chairman of the Board, President and Chief Executive Officer, Dresser Industries, Inc.
Mr. Gerald B. Zornow, Chairman of the Board, Eastman Kodak Co.
Mr. Howard C. Kauffmann, President, Exxon Corp.
Mr. Richard A. Riley, Chairman and Chief Executive Officer, The Firestone Tire and Rubber Co.
Mr. E. Robert Kinney, President and Chief Executive Officer, General Mills, Inc.
Mr. T. A. Murphy, Chairman and Chief Executive Officer, General Motors Corp.
Mr. Colman M. Mockler, Jr., Chairman of the Board and Chief Executive Officer, The Gillette Co
Mr. O. Pendleton Thomas, Chairman of the Board and Chief Executive Officer, The B. F. Goodrich Co.
Mr. J. Peter Grace, President and Chief Executive Officer, W. R. Grace and Co.
Mr. H. J. Heinz II, Chairman of the Board, H. J. Heinz Co.
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Mr. James H. Binger, Chairman of the Executive Committee, Honeywell, Inc.
Mr. Gilbert E. Jones, IBM World Trade Corp.
Mr. Brooks McCormick, President and Chief Executive Officer, International Harvester Co.
Mr. J. Stanford Smith, Chairman and Chief Executive Officer, International Paper Co.
Mr. Richard B. Sellars, Chairman of the Board and Chief Executive Officer, Johnson & Johnson.
Mr. William O. Beers, Chairman of the Board and Chief Executive Officer, Kraftco Corp.
Mr. Thomas S. Carroll, President and Chief Executive Officer, Lever Brothers Co.
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Mr. Harold W. McGraw, Jr., Chairman, President and Chief Executive Officer, McGraw-Hill, Inc.
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Mr. Ralph A. Weller, Chairman of the Board and Chief Executive Officer, Otis Elevator Co.
Mr. Donald M. Kendall, Chairman of the Board and Chief Executive Officer, PepsiCo, Inc.

Mr. Edmund T. Pratt, Jr., Chairman and Chief Executive Officer, Pfizer Inc.
Mr. Ross R. Millhiser, President, Philip Morris Inc.
Mr. Edgar H. Griffiths, President and Chief Executive Officer, RCA Corp.
Mr. Colin Stokes, Chairman and Chief Executive Officer, R. J. Reynolds Industries, Inc.
Mr. Vincent L. Gregory, Jr., President and Chief Executive Officer, Rohm and Haas Co
Mr. Charles D. Dickey, Jr., Chairman and President, Scott Paper Co.
Mr. Joseph B. Flavin, Chairman and Chief Executive Officer, The Singer Co.
Mr. J. Paul Lyet, Chairman and Chief Executive Officer, Sperry Rand Corp.
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Mr. Harry J. Gray, Chairman and President, United Technologies Corp.
Mr. George H. Weyerhaeuser, President and Chief Executive Officer, Weyerhaeuser Co.
Mr. Lester A. Burcham, Chairman, F. W. Woolworth Co.
Mr. C. Peter McColough, Chairman and Chief Executive Officer, Xerox Corp.
Mr. William H. Flynn, Chairman, Chief Executive Officer and President, Zapata Corp.

HEINZ WORLD HEADQUARTERS,
Pittsburgh, Pa., July 22, 1977.

Mr. MICHAEL GLENNON,
Russell Senate Office Bldg.,
Washington, D.C.

DEAR MR. GLENNON: In the recent U.S./U.K. Tax Treaty Hearings, Senator Church voiced questions as to the probable British reaction to a U.S. Senate ratification with reservation. It has taken five years to process the treaty to its present status, and I believe the British reaction to be a matter of grave concern. Some insight can be gained from a review of the U.K. House of Commons debate prior to the U.K. ratification. In case a copy of this transcript of this debate is not in your possession, I am sending a copy to you. You will note:

It was a late hour session, scheduled with little notification or prior preparation.

That Mr. Davies, the Minister of State, Treasury, was the only vocal supporter.

That the other six debaters were unanimously in favor of delay until there was more time for review and until the U.S. had ratified the treaty.

That the principal U.K. concern seemed to be that the ACT Rebate (Integration of Corporate and Shareholder Tax) was too great a concession.

That the ACT Rebate benefits to the U.S. Shareholder and the U.S. Treasury were too great an incentive encouraging excessive dividend distributions from a U.K. subsidiary to its U.S. Parent.

For your convenience, I have taken the liberty of editing the transcript to present the more pertinent language:

"GENERAL

"Mr. DAVIES. The United States is a very important investor in this country, and perhaps more so as a result of North Sea developments than previously, and we have to take that into account. We have also to consider our own balance of payments.

"On balance, I think that we have achieved a fair result. Assuming that the United States Congress ratifies, if this House ratifies, this will become the new double taxation convention between our two countries.

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"The hon. and learned Member for Dover and Deal asked what was going on on the other side of the Atlantic. I think that he will recognise that I have said, as far as I know, what is going on there. The Congress will be asked to ratify.

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"The extent to which we are prepared to pay a tax credit to direct investors is of course a matter of balance having regard to the terms of the convention as a whole. As with the other terms of the convention, at the end of the day it is a question of weighing up the costs and benefits.

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"In conclusion, I would like to say that the new convention with the United States represents a determined effort by both countries to have a convention which is fair to both countries with terms that are properly balanced. It conforms to the principles of the OECD model convention, and this is to be expected, bearing in mind the important part which both the United States and ourselves play in the deliberations of the Committee on Fiscal Affairs of the OCED. This is a major convention, and a great deal of effort and negotiating skill on both sides has gone into getting its terms right. I believe the terms to be very attractive to both British investors in the United States and American investors here, and I commend it to the House.

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"Mr. HORDEN: I cannot pretend, therefore, that the convention is satisfactory as it is. Since it is open to ratification by the USA, it would have been better to have waited until these important points had been satisfactorily resolved. That is what we tried to persuade the Government to do. But we are not opposed to the main purpose of the convention, which is to liberalise trade, payments and investment between our two countries. If only the Government could introduce the same tax levels as exist in the USA, none of these problems would be with us. I fear that that is much to much to expect from this Government. That is why the convention is not as satisfactory as it should be and why we cannot give it the unqualified welcome that it would otherwise deserve.

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"INTERPLAY

"Mr. PAGE. * * * but it seems that the pendulum has been pushed too far forward. I find it extraordinary that these Statutory Instruments have been brought before the House before negotiations with the United States have been concluded.

"Mr. DAVIES. Negotiations with the United States Internal Revenue Service have been completed. The only process left is ratification by the legislature in the way we seek tonight.

"Mr. PAGE. The Minister appears to have a remarkable view of proceedings. Of course negotiations have been completed by the Internal Revenue but it is subject to ratification by the Senate. Considerable discussions there could result in further legislation."

[Mr. Denzil Davis rose.]

"Mr. PAGE. The Minister will have further opportunity to speak. I wonder whether the orders are unamendable in the United States as they are here. If they were amendable, we could have a fair and proper discussion. I hope that the Minister will assure us that the Government's mind is not closed.

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"Mr. FAIRBURN. To which Senate or House of Representatives is the convention to be presented? I understand that a new administration is to take office in 10 days' time. The convention will not be presented before then, and all legislation in America falls, as it does here. How can the Minister say that the American legislature has the convention before it to be ratified.

"Mr. DAVIES. The hon. and learned Gentleman asked me detailed questions about taxation law which are extremely difficult. He now wants me to tell him how the United States legislature orders its affairs. I am not in a position to say.

"Mr. FAIRBURN. The Minister should be.

"Mr. DAVIES. No, I should be foolish to try to do so. The United States legislature will be asked—or perhaps has been asked—to ratify the treaty. If it is ratified by us and by the Americans, it will become a double taxation agreement and convention between us. No doubt the United States Congress will debate these matters as we are doing tonight. It may like or dislike the treaty, but the question for us is whether on the basis of the agreement which the

Executives of the two countries have reached we think it is a fair treaty in the interests of the United Kingdom as a whole.

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"GENERAL

"Mr. WINTERTON. The complaints that have been lodged with me and the representations made to me are that many people were unaware that the measure was to come before the House and that inadequate discussion has taken place. I fully share the view expressed by my hon. and learned Friend the Member for Dover and Deal that these complicated matters would be best discussed by a Select Committee, when all necessary evidence could be taken and considered in an unhurried way. The House has been caught almost by surprise by this debate. Many people who have made representations to me believe that there has been inadequate consultation. Many thousands of people are affected and their case should be properly heard.

"The Minister who has considerable respect on this side of the House, is a learned lawyer. I believe that he thinks that the measure is inadequate, and I hope that he will take up the challenge of my hon. and learned Friend the Member for Kinross and West Perthshire. The best and most just thing he can do is withdraw the order, allow for more adequate discussion, and bring it back when the views on those of the other side of the Atlantic are better known.

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"Mr. FAIRBURN. Why should we pass an order tonight which appears to be final and which would have to be rectified if the matter is still one of dispute and negotiation?"

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"Mr. REES. * * *, it is important for us as the legislators for the United Kingdom to see whether a balance has been struck between the interests of this country and the interests of the United States. I am not asking that we should achieve a favoured position—that would be a juvenile approach to the matter—but we must see whether a fair balance has been struck between the portfolio and direct investments of both countries.

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"I suggest that, against that background and the possibility—not the probability—that the Minister may be here in six months introducing eight new protocols embodied in eight new orders, he should consider withdrawing the order tonight."

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"UNITARY

"Mr. DAVIES. The next question related to the Californian State tax levied on a unilateral basis. The difficulty here is that a United Kingdom company with a subsidiary operating in California is at the moment taxed by the Californian State authorities on what is known as a unitary basis. It pays tax not necessarily on the actual profits made in the State but on the apportionment of the world-wide profit by reference to certain activities in Californa. In other words, the Californian legislature has pased a law not taxing the entity on what it necessarily does in California but looking at the world-wide activity.

"In that kind of situation, the agreement provides that a United Kingdom company will now be taxed in California on an appropriate measurement of its profits in the State of California. Otherwise more tax might be paid than would be reasonable or just. I would have thought that the House would welcome this. Most of the United Kingdom companies operating in California or Oregon would welcome that, but it is all subject to the ratification of the United States Congress.

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"There are two other provisions which are of particular interest. The first is designed to limit the power of constituent States of the United States to compute the State tax liability of United Kingdom enterprises doing business in their territory by reference to business activities of the enterprise which are unconnected with that State.

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"Mr. HORDEN. Furthermore, discussions are still taking place on an amendment which concerns Article 9(4) which I call for convenience, "the California case". At present, California imposes a tax on companies not by virtue of their operation in California alone but by the size of the total payroll of the company throughout the world. The state of Oregon does the same. It is plainly wrong that this situation should continue, and Article 9(4) attempts to put it right. I understand that this is due to be considered, as is the whole Treaty, by the Senate Foreign Relations Committee. So we cannot consider this article as firmly entrenched in the convention which we are asked to approve tonight.

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"INTEGRATION OF CORPORATE SHAREHOLDER TAX (ACT REBATE)

"Mr. DAVIES. The hon. and learned Member then asked about Article 10 and dividends. A United Kingdom portfolio investor in the United States will suffer a 15 per cent withholding tax. A United Kingdom director investor in the United States will suffer a 5 per cent withholding tax. A United States portfolio investor in this country will get the full tax credit which a United Kingdom resident would get in relation to corporation tax, less a 15 per cent withholding tax. A direct investor in this country—which is where the argument has arisen about the imputation system—will get half the tax credit, or 17.5 instead of 35, less a 5 per cent withholding tax on the total. So we have gone half way in relation to direct investment. We have not gone the whole way with portfolio investment. But there is parity of treatment between us and the United States.

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"Mr. REES. First, I believe that it concerns the first major double taxation convention since the imputation system was introduced. As one who was privileged to be a member of the Select Committee that considered the various systems of dividend taxation, I naturally take a close interest in the order, particularly because one of the reasons which led the Select Committee to prefer the imputation system was that it appeared to give the balance of advantage to this country in renegotiating various double taxation conventions with other countries.

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"Mr. HORDEN.—I turn now to what I regard as a major point of friction in the convention itself. When the convention was released in December, 1975, three years had been spent in negotiation, and this was because the introduction of our imputation system produced a much higher effective withholding tax on American companies. That was the reason for the renegotiation.

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"Mr. HORDEN. There will also be an incentive to increase the rate of distribution because the ACT element, and thus the part that can be reclaimed, increases with the amount of distribution.

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"These companies do not invest simply to help Britain's economy. They invest to secure a profit and to remit as high a proportion of that profit as they can. The effect, therefore, of reducing the withholding tax by some 40 per cent will be to increase the other remittances to the United States by a substantial figure.

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"We shall certainly get higher remittances, too. But we shall get nothing like the remittances that will flow to the United States.

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"That being so, it will be more to the advantage of British firms not to remit profits but to retain them in their United States subsidiaries. We make no complaint about reducing barriers to international investment. Indeed, we welcome it. But I trust that the Government are aware of the consequences, which with regard to remittances, look like being far more favourable to the United States, and the US International Revenue Service, than to this country.

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"INTERPLAY

"Mr. CLEMITSON. By far the largest company in my constituency is a wholly-owned subsidiary of an American company, General Motors. I am concerned about the effect, if any, of the order on the payment back to the United States of dividends from the British company. Will the order give a greater incentive to the company and others to distribute profits in the United States in the form of dividends, or to reinvest them? Clearly, it is in the interests of my constituents that any profits should be reinvested in this country so that jobs are preserved.

"Before Christmas I asked a question which has been brought to my attention by a friend of mine who is an accountant. Could the Minister confirm that in the event of a maximum distribution of dividends the effective corporation tax payable by a United Kingdom subsidiary of an American company will be 42 per cent, and not the full rate of 52 per cent, as in the case of a wholly British company?

"Mr. DAVIES. There has been some confusion, if it is not disrespectful to say so, about what has and has not been agreed with the United States. The United Kingdom Executive has agreed with the United States Executive on the terms of a draft convention. The terms are embodied in the order, which has been presented to the United Kingdom legislature for ratification or otherwise. The same convention is being or has been presented to the United States legislature for ratification.

"It is not a question of negotiations continuing between the United Kingdom Executive and the United States Executive. The next process is ratification by each legislature according to its own rules and procedure. The fact that the United States Senate and Congress have not ratified does not mean that we should wait until they have. Why should not they wait until we ratify? No double taxation agreement would ever be ratified on that basis.

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"To be a little disrespectful to one of our Common Market colleagues, the imputation system was invented by the French to be beastly to the Americans. It was designed to make inward investment unattractive. The imputation system makes it less attractive to investors because they may get back less money in dividend. On the other hand, the agreement we have negotiated moves a little bit away from the pure imputation system. It does not go all the way back to the old system, but half way. It gives slightly more incentive for inward investment in this country.

"We have to balance the fact that more dividends can be remitted abroad to the inward investor against the attraction of inward investment into the country. New inward investment from the United States would also create a considerable number of jobs, which we want to see. We have to balance that against the need to ensure that all the profits are not remitted.

"Mr. CLEMITSON. What my hon. Friend is saying is that the effect of the agreement on a subsidiary American company already in the United Kingdom will be to act as an incentive for the company to return more of its surplus to the United States rather than to reinvest it over here. Will it not act as a disincentive to reinvestment?

"Mr. DAVIES. No, I do not think that one can try to distinguish between existing investment of an existing company and new, fresh investment. An existing company is all the time considering fresh investment. I am sure that the great firm in my hon. Friend's constituency is still considering new investment, and whether the masters in Detroit, or wherever it may be, will want to consider it will depend on the taxation policies of this country. By moving away from strict imputation systems, we shall be encouraging the kind of inward investment that my hon. Friend wants to see.

"Mr. HORDEN. Would the hon. and learned Gentlemen give the figures? In 1966, the then Financial Secretary to the Treasury gave the figures of remittance outflow across the exchanges. The hon. and learned Gentlemen must know the figures of the outflow of dividends to the United States. What outflow does he think will occur as a result of this measure?

"Mr. DAVIES. I cannot say what extra outflow, if any, is likely to occur. It depends on the dividend policies of the companies concerned, their need to invest

their profits, and so on. It is impossible to work out how much extra may be remitted to the United States as a result of the measure. I cannot give the House figures of that kind."

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I hope this data will be of some value to the Senator in his deliberations.

Very truly yours,

I. E. ZACHER,
Director, Corp. Taxes and Insurance.

Enclosure.

DOUBLE TAXATION RELIEF (UNITED STATES OF AMERICA)

10.32 p.m.

The Minister of State Treasury (Mr. Denzil Davis). I beg to move,

"That an humble Address be presented to Her Majesty, praying that, on the ratification by the Government of the United States of America of the Convention set out in the Schedule to the Order entitled the Double Taxation Relief (Taxes on Income) (United States of America) Order 1976 a draft of which was laid before this House on 14th April 1976 in the last Session of Parliament, an Order be made in the form of that draft.

"With your permission, Mr. Deputy Speaker, and for the convenience of the House, I suggest that we might debate at the same time the following similar motion relating to double taxation:

"That an humble Address be presented to Her Majesty, praying that, on the ratification by the Government of the Unittd States of America of the Protocol set out in the Schedule to the Order entitled the Double Taxation Relief (Taxes on Income) (United States of America) (No. 2) Order 1976, a draft of which was laid before this House on 9th November 1976 in the last Session of Parliament, an Order be made in the form of that draft.

"Both motions relate to a new double taxation convention with the United States. The new convention replaces the existing convention which dates from 1945 and has been modified on several occasions since then. Although many of the provisions of the new convention are similar to those contained in the earlier arrangements, there are several significant changes. Perhaps the most important relates to dividends.

"The treatment proposed for dividends flowing from the United Kingdom differs from that provided in other orders which have come before the House since the introduction of the imputation system of corporation tax in 1973. In these other orders the tax credit in respect of dividend, paid by a United Kingdom company has been given only to portfolio investors in the partner country —that is to say, to individuals who are resident there and also to companies resident there which control less than 10 per cent of the voting power in the United Kingdom company paying the dividend.

"Under the dividends article in the proposed convention with the United States, the tax credit will be given to United States portfolio shareholders in a similar way to the other orders I have mentioned, but United States direct investors—that is corporations resident in the United States which control 10 per cent or more of the voting stock of the United Kingdom company paying the dividend—will also receive a tax credit. In this case, however—that is to say, in the case of United States direct investors—the tax credit will be less than that payable to portfolio investors.

"In granting a tax credit to direct investors we are recognizing that United Kingdom dividends paid to United States direct investors may find their way out of the corporate sector and into the hands of portfolio shareholders in the United States. This is because under our imputation system of corporate taxation the tax credit is the means by which relief is given for the economic double taxation which occurs when the profits of a company are taxed in its hands and taxed again when they are distributed to shareholders.

"The extent to which we are prepared to pay a tax credit to direct investors is of course a matter of balance having regard to the terms of the convention as a whole. As with the other terms of the convention, at the end of the day it is a question of weighing up the costs and benefits.

"The provision of the dividends article in respect of dividends flowing to the United Kingdom reflects the differences between the company tax systems in the United Kingdom and the United States. The United States has, broadly

speaking, the same system as tht United Kingdom had before the change to the imputation system in 1973. Under the new convention, the American withholding tax levied on dividends flowing from the United States to this country to direct investors will be 5 per cent so long as we pay tax credits in the way provided for in the convention. The rate of withholding tax on other—non-direct—dividends will remain at 15 per cent, as in the convention at present in force.

"There are one or two other aspects of the new convention which I should mention briefly. Our petroleum revenue tax will qualify for tax credit relief in the United States. Also, we shall be able to tax in accordance with our domestic law gains made from the disposal of North Sea licenses—which we could not do under the existing convention.

"The new convention will eliminate the problems which were caused by various technical flaws in one of the articles of the existing convention—Article XV—which gave rise to effects which were quite unintended by both countries when the 1966 Protocol was agreed.

"*There are two other provisions which are of particular interests. The first is designed to limit the power of constituent States of the United States to compute the State tax liability of United Kingdom enterprises doing business in their territory by reference to business activities of the enterprise which are unconnected with that State.* The other provision is aimed at possible abuse of the convention by third country residents who choose to set up companies in either the United Kingdom or the United States solely as a means by which to secure the benefits of the convention.

"I should also like to mention the article of the convention which provides a remedy for the person who is being taxed both by the United States and by the United Kingdom and who considers that the taxation is not in accordance with the terms of the convention. This is Article 25—containing the mutual agreement procedure—and it enables the two Revenues to attempt to resolve the dispute by direct contact with each other.

"This procedure is, I understand, well known to international tax practitioners as the "Competent authority channel" and both we and, I believe, the Americans regard this channel as providing a very valuable means of ensuring the elimination of double taxation. We had a similar provision in the "old" convention, and it always worked well. I hope that the new provision—which is rather more elaborate that the old one—will continue to enable these problems of double taxation to be resolved satisfactorily.

"I ought perhaps to comment briefly on Article 17 of the convention—that is to say, the article concerned with the taxation of public entertainers who are residents of one country and work in the other. The treatment of entertainers under the present treaty—which dates back to 1946—has been changed by Article 17 and brought into line with the recommendations of OECD to give the country in which the earnings arise the right to tax them however short the period of stay in that country.

"Those with relatively small earnings will not be affected but there will be an effect on those earning more than $15,000—or the equivalent in pounds sterling—in a tax year. But the effect on American entertainers coming to work here—for example, to make a film—would not normally be anything like as severe as some representative bodies were at first inclined to think. After discussions with the Revenue and after the article had been explained, they were quite satisfied that the provisions were not as severe as they thought.

"They are not as severe because of the reliefs available under the provisions of the Finance Act 1974 which the present Government introduced in connection with the taxation of "foreign emolaments". It is, of course, not a question of the entertainers having to bear tax in both countries on the same income. Double taxation is eliminated by the country of residence giving credit for the tax paid in the country where the earnings arise.

"*In conclusion, I would like to say that the new convention with the United States represents a determined effort by both countries to have a convention which is fair to both countries with terms that are properly balanced. It conforms to the principles of the OECD model convention, and this is to be expected, bearing in mind the important part which both the United States and ourselves play in the deliberations of the Committee on Fiscal Affairs of the OECD. This is a major convention, and a great deal of effort and negotiating*

skill on both sides has gone into getting its terms right. I believe the terms to be very attractive to both British investors in the United States and American investors here, and I commend it to the House.

"If there are any points relating to this complex document which any hon. Member wants to raise I will, of course, do my best to answer them.

"10.41 p.m.

Mr. PETER HORDERN (Horsham and Crawley). The Minister has said that this is a major convention, and that is so. It will have a profound effect on the flow of funds across the exchanges. He dealt in some detail with some of the provisions, and I am grateful for his explanation of Article 17, as I believe that it will produce some solace to those American visitors—film stars and pop stars—who had thought that their earnings were to be taxed at the United Kingdom rate.

"It is a most important convention, not merely because, as the hon. Gentleman hopes, it will serve as a model for future conventions, but because of its liberalising effect on trade between our two countries. I have some criticisms of the convention, but it should not be thought that simply because the debate is late at night the conveniton is in any way trivial. Hundreds of millions of pounds are involved across the exchanges.

"*The United States has more investment in this country than the United Kingdom has in the United States.* This advantage has been greatly strengthened by the massive investment in recent years by the United States in the North Sea. About £15,000 million has been invested in the North Sea altogether, but a great deal of it has come from American sources. We do not know what the price of oil will be in the next few years, but it is reasonable to expect that it will be higher than at present. We know what the interest charges on the loans so far extended will be.

"We hope that the oil companies will make substantial profits. The country will get revenue through corporation tax from North Sea oil and from the petroleum revenue tax. But the reduction of the withholding tax which the convention allows—or the increase of cash available to the American oil companies made possible by the convention—will inevitably mean much higher remittances to the United States. These remittances would have been very high in any case. The Treasury estimates concerning interest, profits and dividends accruing to overseas countries from North Sea operations are that the outflow will be £750 million this year, £1,250 million in 1979, and £1,750 million in 1980—rather more than double in just three years.

"The effective rate of withholding tax will now be 21·625 per cent. That is a substantial reduction from the position under the imputation system as it existed before. So for this reason, there will be much larger remittances to the United States. I have confirmed this point with one or two American oil companies. *There will also be an incentive to increase the rate of distribution because the ACT element*, and thus the part that can be reclaimed, increases with the amount of distribution.

"For example, if we compare a 25 per cent. dividend distribution with full distribution we get an effective tax rate of 48·77 per cent. on the 25 per cent. distribution, but a tax rate of only 39 per cent. on a full distribution.

"I do not deny that we shall also benefit by the substantial reduction in the United States withholding tax on British companies from 15 per cent. to 5 per cent. We shall certainly get higher remittances, too. *But we shall get nothing like the remittances that will flow to the United States.*

"My first question is: were the Treasury estimates of dividend and interest accruing to the United States from North Sea operations taken with this Convention in mind? If not, what will be the extra flow of funds accross the exchanges to the United States as a result of this substantial reduction in the withholding tax?

"The Minister of State must have these figures and it is right that the House should know what these estimates are. There is bound to be a massive flow of funds amounting, in all probability, to many millions of pounds as a direct result of this measure. Not just the American oil companies will be involved. *There are about 2,000 subsidiaries or United States companies in this country. They have a book value of £5 billion. Their investment last year was said to amount to $4,218 million compared with $2,300 million just three years ago.* The level of investment has been increasing very fast in recent years.

"These companies do not invest simply to help Britain's economy. They invest to secure a profit and to remit as high a proportion of that profit as they can. The effect, therefore, of reducing the withholding tax by some 40 per cent. will be to increase the other remittances to the United States by a substantial figure.

"The House should know what the Treasury estimates of this flow will be. In 1966 the Financial Secretary to the Treasury estimated that the loss to the Revenue on dividends maintained at that time would be only £6 million. He also took into account the effect of investment allowances, which accounted for another £23 million.

"The Ministers of State ought to tell the House what the present estimates are of the extra flow of funds that will occur by the reduction in the withholding tax. We are expecting a great deal from the North Sea. We only hope that the advantage to the balance of payments will be sufficiently large to meet the outflow of these remittances.

"It is reasonable to expect further United States investment here. I wish the same could be said about British investment in the United States. I recognise the substantial advantage for British firms of the withholding tax being reduced from 15 per cent. to 5 per cent. But, unlike American firms, which have to pay no penalty to invest here, British firms have to pay a premium of almost 50 per cent. to invest directly in the United States. That means that scarcely any investment takes place by a straight transfer of funds.

"Money has to be borrowed in the United States, or through the Euro-dollar Market. That being so, it will be more to the advantage of British firms not to remit profits but to retain them in their United States subsidiaries. We make no complaint about reducing barriers to international investment. Indeed, we welcome it. But I trust that the Government are aware of the consequences, *which, with regard to remittances, look like being far more favourable to the United States, and the US International Revenue Service, than to this country.*

"So much for the economic effects of the convention. I now turn to some other matters that should be clarified.

"First, I turn to the film industry, to which the Minister of State referred. The Press has reported that there is considerable concern that, under Article 17, United States entertainers will face substantially increased United Kingdom tax bills on their earnings here. As I read Article 17, the word is "may", and I take it to mean, therefore, that Article 17 is permissive in its effect and that any change in the existing position could be brought about only by special legislation in the Finance Bill. I should be grateful if the Minister would confirm that that is the position.

"I hope that this position would also apply to United Kingdom entertainers in the United States, because the evidence is that the United States Internal Revenue Service takes a quite different view. It does not believe it right that companies should not be taxed if the purpose of forming them is to take control of the services of performers. It seems to have a rather different view of Article 17 than that which the Minister announced. It would be helpful if the Minister could say whether Article 17 is permissive, as it appears to be, and how the Government propose to treat it. I understand that it is to be treated under the Finance Act 1974 in terms of the treatment of American visitors here; that is to say, the same treatment as American residents. Perhaps the hon. Gentleman will confirm that.

"Will the Minister also tell the House about the position of third country partnerships, trusts or estates? Is the fact that a trust may not be resident in either the United States or the United Kingdom likely to mean that a United Kingdom resident may not receive the benefits of the convention on United States source income if the trust should be set up in another country—say, the Bahamas? I hope that the Minister will be able to say whether that is the case.

"Article 7 sets out the definition to 'permanent establishments'. As the term "United Kingdom" includes the Continental Shelf, under that article oil installations would seem to fall within the definition of "permanent establishments" and, therefore, would be taxable. I should be grateful if the Minister would confirm that that is the position.

"There is another small point in Article 8, which affects shipping. This article, incidentally, is the new one in the second draft Statutory Instrument which we are considering. Should not the convention specify exactly what is a ship? The House will recall that we had some trouble about the definition of an oil rig. Is an oil rig a "ship" for the purposes of this article?

"I turn now to what I regard as a major point of friction in the convention itself. When the convention was released in December 1975, *three years had been spent in negotiation, and this was because the introduction of our imputation system produced a much higher effective withholding tax on American companies. That was the reason for the renegotiation.* But the original 1945 convention had itself been substantially amended by the 1966 protocol. Today, even before passing the 1976 convention by means of this draft Statutory Instrument, we are being asked to pass another draft Statutory Instrument—the Double Taxation Relief (Taxes on Income) (United States) (No. 2) Order—which incorporates some amendments and additions made by a protocol last May. So, even before we pass the first Statutory Instrument dealing with the convention as it was originally intended, we find ourselves amending it.

"*Furthermore, discussions are still taking place on an amendment which concerns Article 9(4), which I call for convenience "the California case". At present, California imposes a tax on companies not by virtue of their operation in California alone but by the size of the total payroll of the company throughout the world. The State of Oregon does the same. It is plainly wrong that this situation should continue, and Article 9(4) attempts to put it right.* I understand that this is due to be considered, as is the whole Treaty, by the Senate Foreign Relations Committee. So we cannot consider this article as firmly entrenched in the convention which we are asked to approve tonight. This is one major point which is yet to be ratified, and I ask the Minister to confirm that what I have said is correct. Perhaps he will also say when he expects the treaty to be ratified by the United States, because this is not the only matter in contention. Another matter is yet to be ratified.

"I refer to Article 4 on the definition of fiscal residence, and in particular to the withdrawal of Article 15 of the original 1945 treaty and the effects of the Strathalmond case which followed it. I understand *that Mr. David Forster, International Tax Counsel to the Secretary to the United States Treasury, will soon be negotiating with the Treasury not only on the California case but on the effects of the Strathalmond case.* That concerns the position of what, in shorthand, I call the American wives—that is, the spouses of British citizens resident here.

"I understand that Mr. Forster addressed the International Tax Association in New York on 10th January and said quite specifically that there were *two major items open for negotiation. One was the California case.* The other was the effect of dropping Article 15 of the 1945 convention.

"The dropping of that article caused considerable dismay in the United States, and there is no doubt that the position of American wives of United Kingdom citizens in this country will be changed beyond recognition. *I must, therefore, tell the Minister that we regard this treaty as transitional and subject to further amendment. No doubt it already is because of the California case.*

"The point about the Strathalmond case was that it did not simply affect United States citizens in the United Kingdom but also affected the American banks. As a result of it the Special Commissioners have found that interest received on loans made by one United States bank to another was not taxable by the United Kingdom Inland Revenue, although that interest could be charged as an expense. The real reason—and it was quite justified—for the concern about the Strathalmond case was that the Revenue was losing large sums of money from the American banks, far more than it could ever hope to gain from taxing American wives on their world-wide income. There is, of course, a case for re-negotiation here, but these American ladies should not be made the victims of an attempt to block a serious tax loophole made by the American banks.

"I understand that a joint statement has been made today by the competent authorities in the United States and Britain to the effect that Article 15 of the 1945 treaty was never intended to have the consequences which followed the Strathalmond decision, and that the American banks should have been governed by Article 3. That statement, while helpful, does not, of course, have the force of law, and nobody would object if the Inland Revenue had put out a similar statement to the effect that the old Article 15 was never intended to have the effect seen in the Strathalmond case.

I do not think that American wives of British citizens should be altogether exempt from United Kingdom tax on money remitted and received here. That

would be quite unreasonable. It would seem reasonable if they were taxed on income remitted to this country if they were domiciled abroad, and that was in practice the position of those United States citizens whose domicile had been accepted as being in the United States, even though they were resident here. Their income was taxed on a remittance basis, and that was the position before the Strathalmond case. I assume that it is correct that under the Domicile and Matrimonial Proceedings Act 1973 American women married to Englishmen after 1st January 1974 can still claim United States domicile, and if successful will be taxed on the remittance basis. It is also open to those who married before that date to try to establish domicile in the USA. Perhaps the Minister will confirm that that is the position.

"It is by no means easy to establish domicile abroad. In the Bullock case last year a Canadian who had lived here for 40 years was successful in proving that he was domiciled in Canada. I remember the Minister saying in Committee upstairs that it was extremely difficult to prove domicile, and that one of the ways was to buy a burial plot in the country in which one wanted to be domiciled. If this convention goes through there will be many more grave-diggers in the USA than there have been so far.

"The new agreement does not change the domicile position and does not change the basic remittance position. What it does is to remove the effects of the Strathalmond decision. It will ensure that a great deal of time and effort is taken up by American wives trying to establish United States domicile. It is right that we should consider their position. Of course they complain of the very high levels of tax in this country and the fact that their income is added to that of their husbands. Every Englishman complains of the same thing. What they also see is the different treatment of American men employed here by U.S. corporations and the position of American wives of British subjects.

"The House will recall that in 1974 the Government sought to impose United Kingdom tax on American employees working here if they had been here for five out of the last six years, and to impose tax on their world-wide incomes. There was an enormous row and huge protests from the entire American business community, who simply threatened to leave the country *en masse*. The banks said that they would leave the country. There were representations from the United States Ambassador and the officials of the Bank of England. The Government surrendered completely.

"The position now is that those Americans working here suffer United Kingdom tax on only half of their salary here, and only on income remitted to this country, provided that they are here for not more than nine years, which is not a long time.

"Americans do not understand the subtle distinctions between domicile and residence. All they see is that American men get special tax concessions which are not available to American women, and they see this a blatant sex discrimination, as, indeed, it is.

"The Government have had to make tax concessions to American males in order to keep American business here. The underlying problem is the ludricous rates of tax. If the tax was not so high there would be no need to make concessions to Americans or anyone else. Nor, if we had United States levels of tax, would there be any objection to tax on a world-wide income basis. As it is, there is bound to be considerable protest about this convention in the USA before ratification, because it appears to be a blatant piece of sex discrimination.

"I warn the Government that they will be under considerable pressure to modify the convention by a separate protocol. It seems anomalous that there should be a distinction between United States citizens who are domiciled here and those who are technically resident here. I think that the Domicile and Matrimonial Proceedings Act recognizes this point—that those United States citizens who married United Kingdom citizens before January 1974 should be on the same basis as those who married after that date. I feel sure that there will be strong pressure to renegotiate this point.

"I cannot pretend, therefore, that the convention is satisfactory as it is. Since it is open to ratification by the USA it would have been much better to have waited until these important points had been satisfactorily resolved. That is what we tried to persuade the Government to do. But we are not opposed to the main purpose of the convention, which is to liberalise trade, payments

and investment between our two countries. If only the Government could introduce the same tax levels as exist in the USA, none of these problems would be with us. I fear that that is much to much to expect from this Government. That is why the convention is not as satisfactory as it should be and why we cannot give it the unqualified welcome that it would otherwise deserve.

"11.5 p.m.

Mr. PEIER REES (Dover and Deal): The Minister of State has been, as always, patient and courteous in his exposition of a rather complex order. Normally, any order introducing a measure of double taxation relief is welcome to the House and should be let through without overmuch comment, but, as my hon. Friend the Member for Horsham and Crawely (Mr. Horden) has so ably explained, this is an order of particular importance for a variety of reasons.

"First, I believe that it concerns the first major double taxation convention since the imputation system was introduced. As one who was privileged to be a member of the Select Committee that considered the various systems of dividend, taxation, I naturally take a close interest in the order, particularly because *one of the reasons which led the Select Committee to prefer the imputation system was that it appeared to give the balance of advantage to this country in renegotiating various double taxation conventions with other countries.* Indeed, because this is the first major double taxation convention since the introduction of the imputation system, it may well prove to be a precedent for other orders. Therefore, it needs particular scrutiny by the House.

"Beyond that, the investments of this country in the United States and of the United States in this country are considerable, as are the personal ties between the two countries and the amount of emigration. Therefore, the range of people, businesses and investments likely to be affected is large.

"On the face of things, there is an unanswerable case for the Government's early ratification of the convention and the consequent introduction of the order translating it into domestic law. I understand that the initial agreement was signed in 1975. Therefore, the Minister might argue that there has already been overmuch delay before the introduction of the order. But when I started to investigate the circumstances and the background to the order I developed a certain hesitation about it. I hope that the Minister will go a little more deeply into its general diplomatic background. It must be a matter of delicacy for him to describe what is happening on the other side of the Atlantic. Already one further protocol has had to be signed, which is embodied in the second order. I believe that this is very unusual in this kind of case.

"*Secondly, the United States has not yet ratified the convention.* I believe that the External Relations Committee of the Senate is due to be empanelled next month to consider it and take representations from various interested parties. So there can be no certainty of its ratification by the United States.

"*Thirdly, there is considerable concern in the individual States, particularly California and Oregon, because their tax-raising powers are likely to be affected by the changes in the unitary tax system.* The House would be assisted if the hon. Gentleman would dwell a little on those factors and give his view on whether the convention is likely to pass through smoothly in the United States.

"We understand that there are regular meetings between the United States Internal Revenue Service and the Inland Revenue. It would be interesting to discover whether the order is high on the agenda of matters to be discussed. It may be that both departments regard the matter as signed, sealed and delivered. If so, I suggest that neither has fully appreciated what is at stake.

"I pass from the diplomatic background to some of what my hon. Friend so attractively described as the points of friction in the order which must be of concern to those concerned with in professionally and commercially. In this sort of order, *it is important for us as the legislators for the United Kingdom to see whether a balance has been struck between the interests of this country and the interests of the United States. I am not asking that we should achieve a favoured position—that would be a juvenile approach to the matter—but we must see whether a fair balance has been struck between the portfolio and direct investments of both countries.*

"The Minister dealt only cursorily with this problem, and I hope that he will explain the exact position in more detail later. How will United Kingdom portfolio and direct investments in the United States be treated?

"It is curious that the greater the quantum of distributed profits of a United Kingdom subsidiary of a United States parent company the greater the reliefs. Is this intentional or is it an accidental byplay? Has it been considered by the Inland Revenue? What lies behind it? Why is there to be this discrimination in favour of the subsidiaries of United States parent companies as opposed to branches? Are there deep economic reasons for this situation, or is it one of the hazards of fiscal legislation?

"I hope that the Minister will take a little more time to persuade us that there has been a fair distribution of tax burdens and tax reliefs between the two countries and those who operate in them.

"In electoral terms, entertainers and athletes may not be a significant group, but they are as entitled as any other group to a measure of justice. I wonder whether the Minister of State and those who do his bidding have taken enough care to safeguard the interests of these people when they travel to perform in the United States. Why, for instance, are they denied the relief given under earlier articles to those who perform services in America for less than 183 days in any year? Why should entertainers or athletes who go for just a week or so be denied that relief?

"What is the crucial distinction between dependent and independent services? I do not believe that this phrase has ever appeared before in domestic United Kingdom legislation, although there may be an OECD precedent. It would be helpful to hon. Members and those who study our debates on such esoteric matters if the Minister of State told us the difference between dependent and independent services.

"In this context, what is a "fixed base"? If a pop star performs in California and, in order to avoid being mobbed, takes a house there for the duration of his stay, will this be a fixed base? There are such points of ambiguity on which the Minister owes us a more detailed explanation.

"The American wives of United Kingdom residents or nationals are another group which are not significant in electoral terms; the social fabric and economic structure of this country does not stand or fall on what we do to them in fiscal terms, but they are as entitled to a measure of fiscal justice as any other group in this country. I wonder whether the Minister of State or anyone at Somerset House takes a close interest in such problems.

"There is an uneasy feeling among those who study these matters that the Inland Revenue, having lost the battle with Lady Strathalmond, has chosen to fight that battle over again through this order. That is a rather unattractive way of attacking a very small problem. I believe that in these cases a measure of broad generosity is what we require of the Government. Why is it that an American lady who retains her American nationality but is regarded as domiciled here under the curious domestic provisions of our private international law is now to be subject to tax on her worldwide income? Why is she denied the sort of relief which, as my hon. Friend the Member for Hordern and Crawley so perceptively pointed out, is accorded to an American employee who may be resident here but retains his American nationality and is regarded as domiciled in the United States?

"The Minister of State may say that this problem has been entirely solved by the Domicile and Matrimonial Proceedings Act 1973. But good lawyer as he is, he will recognize that that affects only those ladies who have married since 1973. The hon. Gentleman may say a little ungenerously, and with uncharacteristic lack of chivalry, that those who married before that date are a small and dwindling group. Nonetheless, they form an important group for which we must have a little care.

"Must they take some dramatic step, such as abandoning their husbands for a period of years and buying a house in the United States so as to re-establish their American domicile? This is a matter that could have been solved a good deal more simply and with more generosity.

"It may be that the Minister of State will say that these ladies benefited only by a side wind when the 1966 double taxation convention was introduced. We can only speculate on the motives that led to the introduction of that convention. We know that questions of governmental face come into these matters. The Government may be a little reluctant to withdraw the order, but as the whole matter will soon be at large, especially if it is opened up in the United States Senate, perhaps the hon. Gentleman will promise to come before the House with a protocol dealing a little more generously with this small but important problem.

"Beyond that there are maters of technicality but still of importance. There is the issue of North Sea oil, which looms large in our debates at present. The companies operating in the North Sea are anxious to know whether a drilling rig, for instance, should be regarded as a permanent establishment. The words of the hon. Gentleman, well considered though they may be, will not determine these matters in the courts of law, but it would be of assistance to those who may tender for further blocks in the North Sea if they could discover their exact fiscal position. I have no doubt that they would pay close attention to the Minister of State's words. Perhaps he will say briefly and with his normal succinctness whether he believes that a rig should be regarded as a permanent establishment. Will a drilling company operating in the North Sea be exposed to tax on all its profits from those operations?

"We must also consider partnerships. This is always an arcane, obscure and difficult area. Perhaps the Minister will share his thinking with the House. Contrary to United Kingdom domestic law, it seems that a partnership is to be regarded as a body of persons resident in a particular country. Resident where? What if a partnership contains a United States national, a United Kingdom national and perhaps some foreigner? Where would such a partnership be treated as resident? What happens if the main business of the partnership is controlled from Nassau but it happens to have a branch operating in this country or the United States? Where would that partnership be regarded as resident? Where would it be treated as carrying on its business?

"These are difficult matters, and I do not criticise the Minister of State for not having tackled them in his opening speech. But before we let slip through our hands this difficult and complex order, it is only right that we should press the hon. Gentleman more closely. My hon. Friends who are assiduous in studying these orders will not doubt wish to raise the matters that I have mentioned as well as others if they catch your eye, Mr. Deputy Speaker.

"I suggest that the order possibly needs a little closer scrutiny. One general observation, if I am permitted to make it while keeping within the rules of order, Mr. Deputy Speaker, is that, while I am not one for depreciating and denigrating the political institutions of this country, I wonder whether in the United States they do not handle complex technical matters of this sort in a more sensible way. I wonder whether the proper way to have dealt with this order would not have been through some sort of Select Committee, which could have heard evidence from the interested parties so that the House could then have judged in a dispassionate and non-partisan manner the merits of the order. I wonder whether all these important points have been fully considered by the technical experts who sit in the Official Box behind your right shoulder, Mr. Deputy Speaker, who, on the whole, with great abiilty and integrity consider these matters on our behalf.

"It is not sufficient to be reassured by the Minister of State that all possible representations made to Somerset House have been carefully weighed and that all the objections have been met. I know that our civil servants are people of great devotion to duty and have great skill and deep learning, but, at the end of the day, these are matters of political judgment for us to weigh on the evidence. We cannot delegate these matters to our civil servants, however detached, industrious, and honest they may be. These are matters for us. I believe that it would be better if, like a committee of the United States Senate, we were able to weigh these matters ourselves and not have to rely on verbal assurancces by the Minister of State or on a chance letter to us.

"I suggest that the Leader of the House—not the Minister of State, because I recognise that he has a limited influence in this sphere—would be well advised to attend our debates on these small esoteric matters, because they often show up matters of considerable constitutional importance. If the Leader of the House were to study our debate tonight, he might have food for thought. I suggest that he might pause to consider whether we handle these matters as expeditiously, carefully and skillfully as the legislatures of other Powers. I say that with a certain diffidence and almost humility, because I was taught to believe that we ordered these matters extremely well in this country. However, I wonder whether we ought to update our constitutional procedures. With your characteristic generosity, Mr. Deputy Speaker, you have allowed me to stray outside the strict rules of order.

"I suggest that, against that background and the possibility—not the probability—that the Minister may be here in six months introductng eight new protocols embodied in eight new orders, he should consider withdrawing the

order tonight. After all, it would be wrong to ask the House to rush in where senatorial angels fear to tread or, if not fear to tread, at least prepare to tread with more circumspection than the Minister has shown tonight.

"11.23 p.m.

"Mr. JOHN PAGE (Harrow, West): I read these Statutory Instruments with great care, but I have to say that my understanding was not completely clear afterwards. I felt rather as the accountancy students felt after listening to a high level lecture by a professor: he confessed that he was still confused, but at a much higher level. Having listened to the interesting and extremely clear speeches made by my hon. Friends and by the Minister of State, I am in much the same state of confusion.

"I should like to ask the Minister two simple, straightforward questions. *The first concerns Article 10. Will he confirm that the treatment of profits made by British firms in America is identical with the treatment of profits made by American firms in this country?* In particular, *is there any difference between the treatment of distributed and non-distributed profits?* It is important to have that made clear.

"The United Kingdom is by far the largest overseas investor, except for the United States, of any industrial country. I assume that the proportion will be similar for the United States. That is important because because of the doubts in the minds of those involved in international business that the treatment is not completely even-handed.

"My hon. Friend the Member for Horsham and Crawley (Mr. Hordern) put the position of American wives brilliantly. Perhaps the Strahalmond case ruling produced too favourable a result for the spouses, but it seems that the pendulum has been pushed too far forward. *I find it extraordinary that these Statutory Instruments have been brought before the House before negotiations with the United States have been concluded.*

"Mr. DENZIL DAVIES. *Negotiations with the United State Internal Revenue Service have been completed. The only process left is ratification by the legislature in the way we seek tonight.*

"Mr. PAGE: The Minister appears to have a remarkable view of proceedings. Of course negotiations have been completed by the Internal Revenue but it is subject to ratification by the Senate. Considerable discussions there could result in further legislation.

"[Mr. Denzil Davies *rose.*]

"Mr. PAGE: The Minister will have a further opportunity to speak.

"I wonder whether the orders are unamendable in the United States as they are here. If they were amendable, we could have a fair and proper discussion. I hope that the Minister will assure us that the Government's mind is not closed.

"11.28 p.m.

"Mr. NICHOLAS FAIRBAIRN [Kimross and West Perthshire]. I am particularly concerned about the taxation of American wives. I have no interest to declare—I do not have an American wife and I do not believe that there are any in my constituency—but, as a matter of justice, this is an issue of importance.

"I was impressed by what the Minister said, although he said it—unusually for him as a distinguished lawyer and hon. Member whom I respect—more because of what he had been advised to say than because of what he thought was wise to say. I was impressed by the argument of my hon. and learned Friend the Member for Horsham and Crawley (Mr. Hordern) and by that advanced by my hon. and learned Friend the Member for Dover and Deal (Mr. Rees).

"The Minister will certainly not find the answers to my questions in his brief, but it is important that such matters be considered. The question of the three matters—entertainers, the California situation and the Strathalmond case—was raised by my hon. Friend the Member for Horsham and Crawley. Is it or is it not the case that these matters are subject to negotiation at the next meeting of Finance Ministers in nine days' time? If not, upon what basis am I informed that Mr. Forster said that these three matters of protocol were still subject to discussion?

"If the order goes forward tonight, is that likely to prejudice the negotiations on these three matters, whenever they occur? If it will not prejudice them, why not? It seems to me that it would prejudice them.

"I am considerably concerned about the prejudice that will arise—I know the situation that existed before the Strathalmond case—in the differentiation between those who are wives, who happen to be Amercian citizens, of British subjects and those who happen to be American males. The Labour Party has been devout in its concept that men and women should be treated equally, and equally devout in the concept that all races should be treated equally, although if they are distinguished in colour and tongue it is sometimes easier to make that distinction.

"It is the fact, however, that under the order American wives will be treated differently from American males. The only possible justification upon which one can base that is the old concept that the wife is a chattel and is somehow united as a *unum quid* with the husband if she happens to be mug enough to marry him. I do not see how it can be regarded as just by the Labour Party—and I am sure not by a lawyer of such distinction as the Minister—that a woman who happens to be married to a British person—a number of my hon. Friends have said "English person" as if it was inevitably consequential—should have the whole of her income aggregatedl for tax here, whereas a man who happens to be married to a British women does not suffer that penalty. That seems to me a grave and difficult distinction to justify, particularly in the light of all the law that we have passed, if in no other time, in this Parliament.

"Will the Minister justify why he thinks that it is right to put forward an order tonight under which the whole income which is not brought to this country of a woman who happens to suffer being married to a British husband should be taxed, but the whole income of an American man who happens to suffer being married to a British woman and is resident in this country should not thought that matter out, I think that they should.

"I respect the Minister because he is not like the Secretary of State for Defence, who appeared incapable of either understanding or answering any question that was put to him this evening. It is a simple question and I should like a simple answer. Why is that justified? Why is it right that an American wife should have income which never comes to this country taxed in aggregate with her husband's, which at 98 per cent. means confiscation, whereas her husband should not have if affairs are in reverse? Is sex discrimination still part of the fiscal policy of the present Government, or is it not? If they have not thought that matter out, I think that they should.

"Secondly, why is it that the American negotiators at this monh's negotiations considered that the three matters outstanding were subject to negotiation and that the Government take the view that they are not? *Why should we pass an order tonight which appears to be final and which would have to be rectified if the matter is still one of dispute and negotiation?*

"It is a matter that concerns only a small number of people. It concrens only those who happen to be resident wives in Britain. They may be a small number, but I have always understood that if the Labour Party stands for anything, it stands for the rights of minorities and for the concept of justice and equality.

"The question of equality is a matter of debate in the country of the nationals we are considering. There is not the slightest question but that those who have had the misfortune to be born as women and who have had either the judgment or the misjudgment to have married British citizens and to have come to reside here will be punished in a different way from those who happen to have a different sex or a different domicile. That in all equity must surely be wrong, and if the Minister can justify it, I hope that he will. I am sure that he cannot justify it and, for the very cogent and much more informed reasons that my hon and learned Friend the Member for Dover and Deal and my hon. Friend the Member for Horsham and Crawley adduced, I think that the Government would be wise to withdraw the order tonight, to reconsider it, and to enter into the negotiations which both sides want before reaching a conclusion which will be proved to be wrong, which may be prejudicial to the negotiations which will take place, and which will inevitably have to be amended at a larger stage, possibly at a cost of much pain and embarrassment.

"11.37 p.m.

"Mr. Nicholas Winterton (Macclesfield). I shall be very brief, because I do not pretend to be able to fathom all the intricacies of tax and double taxation and conventions such as those we are debating.

"One of the duties of a Member of Parliament is to represent his constituents and, whether he has many constituents affected by a measure such as this or very few, it is only right that the case should be heard. I therefore fully support all the views advanced by my hon. Friend the Member for Horsham and Crawley (Mr. Hordern) and also the very eloquent speeches of my hon. and learned Friends the Members for Dover and Deal (Mr. Rees) and for Kinross and West Perthshire (Mr. Fairbairn).

"The Minister seemed to imply that this treaty had been ratified. It has not been ratified. I hope that I am correct in saying—perhaps the Minister will confirm this—that the United States Treasury officials are willing to discuss the problems of American wives here in the United Kingdom and the concept of an amendment to the treaty at their meeting with their counterparts in the United Kingdom later this month. I hope that the Minister of State will be prepared to confirm that this is the case and thta the treaty is not likely to be ratified until, perhaps, February or March and that the United States Senate will be discussing many of the problems that have been raised in the House of Commons and that are being raised in the United States.

"The complaints that have been lodged with me and the representations made to me are that many people were unaware that the measure was to come before the House and that inadequate discussion has taken place. I fully share the view expressed by my hon. and learned Friend the Member for Dover and Deal that these complicated matters would be best discussed by a Select Committee, when all necessary evidence could be taken and considred in an unhurried way. *The House has been caught almost by surprise by this debate.* Many people who have made representations to me believe that there has been inadequate consultation. Many thousands of people are affected and their case should be properly heard.

"The Minister, who has considerable respect on this side of the House, is a learned lawyer. I believe that he thinks that the measure is inadequate, and I hope that he will take up the challenge of my hon. and learned Friend the Member for Kinross and West Perthshire. *The best and most just things we can do is withdraw the order, allow for more adequate discussion and bring it back when the views on those of the other side of the Atlantic are better known.*

"The Minister should understand the position particularly of the American wives in this country who will be hardly hit. I know that, like the Chancellor, he believes that rates of taxation in this country are penal. The order is final so far as this House is concerned, despite discussions which may necessitate a further debate. Our case is fair, and I hope that the Minister will accede to it.

11.42 p.m.

"Mr. Ivor Clemitson (Luton East). The hon. Member for Macclesfield (Mr. Winterton) said that he was not very well briefed on taxation matters, and I am even less so, but, as he also said, one should take an interest in these matters if they affect one's constituents. By far the larest company in my constituency is a wholly-owned subsidiary of an American company, General Motors. I am concerned about the effect, if any, of the order on the payment back to the United States of dividends from the British company. *Will the order give a greater incentive to that company and others to distribute profits in the United States in the form of dividends, or to reinvest them?* Clearly, it is in the interests of my constituents that any profits should be reinvested in this country so that jobs are preserved.

"Before Christmas I asked a question which had been brought to my attention by a friend of mine who is an accountant. *Could the Minister confirm that in the event of a maximum distribution of dividends the effective corporation tax payable by a United Kingdom subsidiary of an American company will be 42 per cent. and not the full rate of 52 per cent. as in the case of a wholly British company?*

"11.44 p.m.

"Mr. Denzil Davies. There has been some confusion, if it is not disrespectful to say so, about what has and has not been agreed with the United States. The United Kingdom Executive has agreed with the United States Executive on the terms of a draft convention. The terms are embodied in the order, which has been presented to the United Kingdom legislature for ratification or otherwise. The same convention is being or has been presented to the United States legislature for ratification.

"It is not a question of negotiations continuing between the United Kingdom Executive and the United States Executive. The next process is ratification by each legislature according to its own rules and procedure. *The fact that the United States Senate and Congress have not ratified does not mean that we should wait until they have. Why should not they wait until we ratify? No double taxation agreement would ever be ratified on that basis.*

"Mr. FAIRBAIRN. To which Senate or House of Representatives is the convention to be presented? I understand that a new administration is to take office in 10 days' time. The convention will not be presented before then, and all legislation in America falls, as it does here. How can the Minister say that the American legislature has the convention before it to be ratified.

Mr. DAVIES. The hon. and learned Gentleman asked me detailed questions about taxation law which are extremely difficult. He now wants me to tell him how the United States legislature orders its affairs. I am not in a position to say.

"Mr. FAIRBAIRN. The Minister should be.

"Mr. DAVIES. No, I should be foolish to try to do so. The United States legislature will be asked—or perhaps has been asked—to ratify the treaty. If it is ratified by us and by the Americans, it will become a double taxation agreement and convention between us. *No doubt the United States Congress will debate these matters as we are doing tonight. It may like or dislike the treaty, but the question for us is whether on the basis of the agreement which the Executives of the two countries have reached we think it is a fair treaty in the interests of the United Kingdom as a whole.*

"The hon. Member for Horsham and Crawley (Mr. Hordern) and my hon. Friend the Member for Luton, East (Mr. Clemitson) asked about income being remitted from this country with particular reference to North Sea investment as a result of the half tax credit given under the convention to American direct investment. Under our imputation system, without the convention there would be less incentive for inward investment in the United Kingdom. The hon. and learned Member for Dover and Deal (Mr. Rees) and I were on the Select Committee that discussed the matter.

"*To be a little disrespectful to one of our Common Market colleagues, the imputation system was invented by the French to be beastly to the Americans. It was designed to make inward investment unattractive. The imputation system makes it less attractive to investors because they may get back less money in dividend.* On the other hand, the agreement we have negotiated moves *a little bit away from the pure imputation system. It does not go all the way back to the old system but half way.* It gives slightly more incentive for inward investment in this country.

"*We have to balance the fact that more dividends can be remitted abroad to the inward investor against the attraction of inward investment into the country.* New inward investment from the United States would also create a considerable number of jobs, which we want to see. We have to balance that against the need to ensure that all the profits are not remitted.

"The substantial inward investment in the North Sea by American companies benefits enormously—and will do so increasingly—United Kingdom finances and the balance of payments. We cannot approach this from the basis that the imputation system is perfect from an insular point of view. The imputation system would militate against inward investment, and it has been slightly modified in respect of the United States.

"Mr. CLEMITSON. *What my hon. Friend is saying is that the effect of the agreement on a subsidiary American company already in the United Kingdom will be to act as an incentive for the company to return more of its surplus to the United States rather than to re-invest it over here. Will it not act as a disincentive to re-investment?*

"Mr. DAVIES. No, I do not think that one can try to distinguish between existing investment of an existing company and new, fresh investment. An existing company is all the time considering fresh investment. I am sure that the great firm in my hon. Friend's constituency is still considering new investment, and whether the masters in Detroit, or wherever it may be, will want to consider it will depend on the taxation policies of this country. By moving away from strict imputation systems, we shall be encouraging the kind of inward investment that my hon. Friend wants to see.

"Mr. HORDERN. Would the hon. and learned Gentleman give the figures? In 1966, the then Financial Secretary to the Treasury gave the figures of remittance outflow across the exchanges. The hon. and learned Gentleman must know the figures of the outflow of dividends to the United States. What outflow does he think will occur as a result of this measure?

"Mr. DAVIES. I cannot say what extra outflow, if any, is likely to occur. It depends on the dividend policies of the companies concerned, their need to invest their profits, and so on. It is impossible to work out how much extra may be remitted to the United States as a result of the measure. I cannot give the House figures of that kind.

"The hon. Member for Horsham and Crawley raised a point, under Article 17, about the film industry. He asked whether the article was permissive. Part of it is. I understood him to be referring to the part relating to companies. In other words, if an American film star came here and did not get paid himself for his services but was employed by a non-resident company and the money was paid to that company, under our law, if the non-resident company was operating here—it probably would not be—we would have no power to pierce the corporate veil and look beyond to find where the money was actually going. In such cases, therefore, the provision is permissive. If there were any change, it would have to be done through our domestic legislation.

"The hon. Gentleman asked whether trusts established in the Bahamas will benefit under the convention. The answer is that they will not. The convention is only concerned with giving benefits to trusts established in the two contracting countries. It would defeat the object to give the benefit to tax havens, such as the Bahamas.

"The hon. Gentleman also asked whether oil installations or drilling rigs were permanent establishments. I am not going to give legal advice from this Box to any company. It is a question of fact at the end of the day. But I should have thought generally that an oil installation or a drilling rig would come within the terms of being a permanent establishment. But that will be subject to the facts of a particular case. In general, I think it may be argued that such things are permanent establishments. I was also asked whether oil rigs were ships. I shall not answer that, but no doubt some are and some are not.

"*The next question related to the Californian State tax levied on a unilateral basis. The difficulty here is that a United Kingdom company with a subsidiary operating in California is at the moment taxed by the Californian State authorities on what is known as a unitary basis. It pays tax not necessarily on the actual profits made in the State but on the apportionment of the world-wide profit by reference to certain activities in California. In other words, the California legislature has passed a law not taxing the entity on what it necessarily does in California but looking at the world-wide activity.*

"*In that kind of situation the agreement provides that a United Kingdom company will now be taxed in California on an appropriate measurement of its profits in the State of California. Otherwise more tax might be paid than would be reasonable or just.* I would have thought that the House would welcome this. Most of the United Kingdom companies operating in California or Oregon would welcome that, but it is all subject to the ratification of the United States Congress.

"Several hon. Members drew attention to Article 15 of the previous Treaty and to the problem of American wives—the Strathalmond case. It is not a matter of discrimination against a man or woman, subject to the domicile point that I shall come to. The point is that up to 1966, as I understand it, and now under the new agreement, an American citizen resident in this country would have borne United Kingdom tax on dividends arising in the United States. Credit would no doubt have been given before 1966 and credit will be given now under the new agreement for any American tax payable on these dividends.

"However, as a result of the Strathalmond case, which arose from an amendment in 1966 to the original treaty, it was decided that an American citizen resident in this country was not taxable in respect of American dividends and therefore not subject to British income tax. That was never intended in the original treaty. It only arose as a result of that amendment in 1966. It was one of the unintended consequences, but the Strathalmond case decided accordingly.

"What we are now proposing is simply that an American citizen resident in this country who receives dividends from the United States shall be taxable to a United Kingdom tax. There is nothing reprehensible about that. That seems to be a perfectly normal proposition.

"Mr. PETER REES. The Minister said that was not intended in the 1966 Convention. What can he adduce in support of that proposition? Can he refer to any passage in *Hansard*, or any document, or must we take it on trust?

"Mr. DENZIL DAVIES. For the moment the hon. and learned Gentleman had better take it on trust. I shall write to the hon. and learned Gentleman and tell him why this was so, but I now want to get on and try to answer all the points that were raised.

The domiciile issue is subsidiary to the main point. That is slightly different because as a result of the Domicile and Matrimonial Proceeding Act, after 1st January 1974 a woman could chose a different domicile from that of her husband. An American lady resident in this country could in theory choose to keep her American domicile. I realise that would be difficult, because domicile is a question of fact. But I accept that there might be an instance when someone was domiciled in the United States despite the fact that she was living in this country at the same time.

"In that kind of case, after this treaty is ratified by both legislatures and if the woman is married after 1st January 1974, United Kingdom tax on American dividends will only be paid on the remittance basis. In other words, if the dividends are not remitted to this country, no tax will be payable. That will be different from the position before the Domicile and Matrimonial Proceedings Act 1973.

"Without entering into any commitment, we shall look at this. But I want to stress that that does not mean that we shall change it. We shall look at it within the confines of the Treaty to see whether it might not be possible to equalise the treatment of the pre-1st January 1974 with the post-1st January position. But I say that without commitment.

"The hon. and learned Member for Dover and Deal asked what was going on on the other side of the Atlantic. I think that he will recognise that I have said, as far as I know, what is going on there. The Congress will be asked to ratify.

"The hon. and learned Member then asked about Article 10 and dividends. A United Kingdom portfolio investor in the United States will suffer a 15 per cent withholding tax. A United Kingdom director investor in the United States will suffer a 5 per cent withholding tax. A United States portfolio invester in this country will get the full tax credit which a United Kingdom resident would get in relation to corporation tax, less a 15 percent withholding tax. A direct investor in this country—which is where the argument has arisen about the imputation system—will get half the tax credit, or 17.5 instead of 35, less a 5 per cent withholding tax on the total. *So we have gone half way in relation to direct investment. We have not gone the whole way. We have gone the whole* way with portfolio investment. But there is parity of treatment between us and the United States.

"The hon. and learned Member asked what was the difference between dependent and independent srvices. I am afraid that I cannot give a very satisfactory answer. My understanding is that dependent services mean wages, remuneration for personal services provided by someone in the employment of someone else, whereas independent services are personal services not in employment, when a person is a sole trader providing personal services.

"Finally, the hon. and learned Member asked where a partnership would be resident. I am afraid that that is a question of fact in these cases. I cannot give him a definitive answer.

"*I hope that I have dealt with all the question that were put to me. I think that this is a fair and balanced treaty.* Ministers always say that about almost every treaty, of course. But the interests of this country have been maintained. The United States is a very important investor in this country, and perhaps more so as a result of North Sea developments than previously, and we have to take that into account. *We have also to consider our own balance of payments.*

"On balance, I think that we have achieved a fair result. Assuming that the United States Congress ratifies, if this House ratifies, this will become the new double taxation convention between our two countries.

"Question put and agreed to.

"Resolved,

"That an humble Address be presented to Her Majesty, praying that, on the ratification by the Government of the United States of America of the Convention set out in the Schedule to the Order entitled the Double Taxation Relief (Taxes or income) (United States of America) Order 1976, a draft of which was laid before this House on 14th April 1976 in the last Session of Parliament, an Order be made in the form of that draft.

"To be presented by Privy Councillors or Members of Her Majesty's Household.

"INCOME TAX

"Resolved,

"That an humble Address be presented to Her Majesty, praying that, on the ratification by the Government of the United States of America of the Protocol set out in the Schedule to the Order entitled the Double Taxation Relief (Taxes on Income) (United States of America) (No. 2) Order 1976, a draft of which was laid before this House on 9th November 1976 in the last Session of Parliament, an Order be made in the form of that draft.—[*Mr. Denzil Davies.*]

"To be presented by Privy Councillors or Members of Her Majesty's Household.

"PROCEDURE (SESSIONAL COMMITTEE)

"Ordered,

"That the matters of Questions to the Prime Minister, the operation of Standing Order No. 9, the eligibility of Members successful in ballots for Notices of Motions and Bills to take part in subsequent ballots and the tabling of Amendments to a Bill on the day it receives a Second Reading be referred to the Sessional Committee on Procedure.—[*Mr. Stoddart.*]"

PATTON, BOGGS & BLOW,
Washington, D.C., August 3, 1977.

Re U.S.-U.K. Tax Treaty.

Hon. JOHN SPARKMAN, *Chairman,*
Committee on Foreign Relations, U.S. Senate,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of Bellefonte Insurance Company, I am pleased to submit herewith the written statement of Bellefonte for filing with your committee with respect to the pending U.S.-U.K. Tax Treaty.

Bellefonte strongly urges the immediate ratification of this Treaty for the reason that the Treaty would eliminate double taxation of underwriting income earned by Bellefonte's U.K. branch from its insurance of U.S. risks. In the absence of the Treaty, this income is subject to both U.S. and U.K. tax. without allowance for foreign tax credit.

The Treaty contains many other provisions of *critical* importance to U.S. companies and their shareholders. The Treaty has been carefully worked out by the Treasury Department over many years, has already been approved by the United Kingdom, and should be ratified as promptly as possible. In this regard, we are concerned about the possible reservation of Article 9(4). We understand that the United Kingdom has indicated it will not accept such a reservation; therefore, the reservation jeopardizes the entire Treaty including relief from double taxation for U.S. insurance companies.

Respectfully submitted.

EDWARD T. MITCHELL.

Enclosure.

STATEMENT OF ROBERT C. LEE, PRESIDENT, BELLEFONTE INSURANCE COMPANY

Bellefonte Insurance Company, an affiliate of Armco Steel Corporation, is a Kentucky corporation which, together with related insurance companies, is licensed to underwrite multiple lines of insurance and reinsurance in most states in the United States as well as in several foreign countries, including the United Kingdom. Through its London agent, Bellefonte participates as an underwriter and reinsurer in the Lloyds of London system. A large number of U.S.

risks not readily insurable in the United States are insured abroad, either because of the peculiar nature of the risk or the amount involved. In Bellefonte's case, approximately sixty-five percent of the premiums of its London operation are paid for in U.S. dollars.

Bellefonte strongly supports ratification of the United States-United Kingdom income tax treaty currently pending before this Committee. Specifically, Bellefonte supports Article 23(3), which would eliminate the double taxation of underwriting income derived from the insurance of U.S. risks through a permanent establishment in the United Kingdom. In addition, other provisions of Article 23, as well as Articles 9(4) and 10, provide relief from double taxation for other types of income. Bellefonte objects to a reservation on any article, such as Article 9(4), because such a reservation could jeopardize the entire treaty.

For fifty-four years prior to the enactment of Section 1036 of the Tax Reform Act of 1976, the source of underwriting income was the place of negotiation and execution of the contract. *See* A.A.R. 723, I-1 Cum. Bull. 113 (1922). Thus, underwriting income arising from a permanent establishment in the United Kingdom, which is taxable by the United Kingdom under Article III of the existing treaty and would be so taxable under Article 7 of the proposed treaty, has traditionally been considered to be foreign source income for U.S. federal income tax purposes. U.K. taxes imposed on such income qualified for the foreign tax credit in determining such taxpayer's U.S. tax liability. As a result of Section 1036 of the Tax Reform Act of 1976, the source of underwriting income is now determined solely by the location of the risk. Thus, effective January 1, 1977, underwriting income arising from the insurance of U.S. risks through a permanent establishment in the United Kingdom would be subject to tax both in the U.S. and in the U.K. Further, the U.K. tax imposed on such underwriting income would not be entitled to the foreign tax credit as an offset against the U.S. tax because such income is considered under the 1976 Act to be U.S. source income. Article 23(3) would alleviate this inequitable result by providing that underwriting income earned by a U.S. insurance company which is subjected to tax in the United Kingdom will be deemed for source rules to be from income earned in the United Kingdom. The effect on Bellefonte would be that the U.K. tax imposed on its underwriting income in the U.K. would not expose the same income to U.S. tax without the benefit of the foreign tax credit.

In addition, the new "location of risk" source rule of Section 1036 creates serious administrative and compliance problems in that it is often difficult, if not impossible, to identify where a specific risk is located, particularly with marine and aviation insurance or whole account reinsurance of a company's total book of business. The ratification of the treaty should make identifying the location of each risk insured through a permanent establishment in the United Kingdom unnecessary.

The passage of Section 1036 of the 1976 Act is not only a radical departure from prior U.S. policy, but it is also a serious departure from the source rules followed by major European trading partners, such as the U.K. and Germany. Article 23(3) of the pending treaty with the United Kingdom recognized the need for U.S. taxpayers to compete in world markets on an equal footing with its trading partners. Unless the treaty is ratified, U.S. insurance companies will be seriously disadvantaged in their efforts to compete effectively in major insurance markets, such as the United Kingdom.

In conclusion, the proposed United States-United Kingdom income tax treaty should be ratified promptly. Article 23(3) would relieve U.S. insurance companies from the discriminatory double taxation resulting from Section 1036 of the Tax Reform Act of 1976. Article 9(4) is very important to the United Kingdom, so that a reservation thereon may well jeopardize the entire treaty. In addition, Articles 10 and 23 provide substantial benefits for U.S. shareholders of U.K. corporations.

STATEMENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

The National Association of Manufacturers represents 13,000 members primarily engaged in manufacturing and employing a majority of the industrial labor force in the United States.

The Association appreciates this opportunity to comment on the proposed tax treaty between the United States and the United Kingdom. The provisions of this treaty are of critical importance to both U.K.-controlled firms doing business in the U.S. and U.S.-controlled firms doing business in the U.K.

The NAM strongly supports the proposed treaty as a whole and Article 9(4) in particular. This treaty has been scrupulously and carefully negotiated by the U.S. Treasury over a period of several years. It has also been approved by both the present and previous Administrations. Of particular importance are three Articles which would affect many of the NAM's members. The first two, Articles 10 and 23, would extend to U.S. companies doing business in the U.K., the benefits of the recently integrated U.K. tax system. Through these provisions, double taxation of distributions to U.S. shareholders would be ended. The third provision is Article 9(4) which would prohibit states from covering U.K. parents of local subsidiaries under the state's unitary tax system. The provisions of the treaty now strike a very delicate balance of interests, important to both the U.S. and the U.K. Significant changes, such as reservations concerning Article 9(4), would upset this balance and seriously endanger the entire treaty.

ADVANTAGES OF THE INTEGRATED TAX SYSTEM

This treaty, if ratified, would be the first to extend to U.S. subsidiary operations in foreign countries the benefits of an integrated tax system. Under such a system, corporate and personal taxation is integrated into one comprehensive system. This approach, recently adopted by the U.K., Canada, and several European countries, eliminates much of the current double taxation and simplifies reporting to a large extent. The provisions not only represent major concessions to the U.S., which will result in additional revenue to domestic shareholders and to the U.S. Treasury, will also set an important precedent for future negotiations with other countries.

One of the benefits which will accrue to U.S. business by these concessions is inclusion of U.S. stockholders in the United Kingdom's integrated tax system. Under the current treaty, the U.K. does not allow a credit for U.K. corporate taxes paid by a U.K. subsidiary when a distribution is made to a U.S. shareholder. The U.K. also applies a 15 percent withholding on the dividend. The effect of inclusion would be to end this current double taxation of dividends from U.S. subsidiaries based in the U.K.

Under Articles 10 and 23, the U.K. would extend to U.S. shareholders a refundable tax credit equal to the tax already paid by the U.K. subsidiary on the earnings distributed (Many non-U.S. portfolio investors are presently allowed the credit by other tax treaties.) The effect of this provision would be to reduce the effective U.K. tax rate on U.K. subsidiaries of U.S. parents from 52% to 42%. The Treasury will then recoup the difference between the 42% rate paid to the U.K. and 48%, which is the effective U.S. rate. Thus the effect of this reduction is beneficial both to the U.S. shareholder and to the Treasury.

UNITARY TAX SYSTEM

Article 9(4) has been negotiated to serve as a *quid pro quo* for the favorable treatment the U.S. receives in Articles 10 and 23. Simply stated, the provision precludes a state using the "unitary formula" of taxation from taxing a U.K. parent corporation's income through U.S. subsidiaries although the parent itself does not do business in the U.S.

The unitary business concept has become well established in the U.S. as applied to multistate businesses. A state will apply an apportionment formula, dividing the corporate business income among all the states in which it is earned. The tax is then computed on the portion attributed to the taxing state. This process, however, becomes infinitely more complex when conducted by more than two affiliated corporations, especially on an international basis.

The existing rules of tax conventions between the U.S. and other countries prohibit this approach by a Contracting Nation. Article 9(4) would simply extend this prohibition to state and local jurisdictions.

There are a number of reasons for ratification of Article 9(4). First, an extraterritorial tax like the unitary system type disrupts international trade in several ways. Foreign-based multinational corporations with subsidiaries in a state which uses this unitary approach are faced with tax planning problems

not only for the parent and for the subsidiary but also with the combined reporting required to compute tax on the overall business of both.

This unusual burden also discourages investment in the U.S. and particularly those states which use the unitary system as applied to foreign parent companies. Not only does the unitary approach have a dampening effect on new investment, but it also encourages existing multinational corporations to relocate outside the state, the obvious result of which is loss of investment, jobs, and tax revenue. Furthermore, that loss may very well be to the entire U.S. economy as well as to the particular state if the corporation feels it is not economically feasible to relocate elsewhere in the U.S.

A second reason for the Senate to ratify this treaty is the improved bargaining position it would give to the U.S. Treasury. If the U.S. can, by approving Article 9(4), obtain the benefits of the U.K. integrated tax system, it will be in a much stronger position in its negotiations with France and Germany, both of which have similar integrated systems. If this advantage is lost or continuation of the unitary approach brings retaliatory measures, foreign nations will demand, with good reason, further U.S. concessions in future treaties. These concessions in the long run could well lead to greater revenue losses to the states than the unitary tax approach would raise.

IMPACT OF ARTICLE 9(4) ON THE STATES

No accurate determination has yet been made to substantiate the claim that large revenue losses to the states would result if Article 9(4) were ratified. The California Franchise Tax Board has estimated that the revenue loss would be $125,000,000. However, the Board submitted no figures to substantiate this estimate, nor did it indicate how its computation was made.

There are several other points which should be noted in consideration of Article 9(4). The states feel that since they have not abused the system, there is no cause for its abolition. Furthermore, the argument goes, if it is determined that it is in the best interests of commerce to eliminate the unitary approach, it should be accomplished by Congress through the normal legislative process rather than by treaty.

This line of reasoning takes into account neither the fact that, whether or not the system is "abused," it is a deterrent to investment nor the problems attending passage of appropriate legislation. The very existence of the combined reporting is a burden which has a deterrent effect on business location decision-making. Secondly, the business community has for years been attempting to work out federal legislation which would alleviate this situation. The state taxing authorities, however, continue to reject these proposals out of hand. In any case, *this* treaty approach is before Congress, and no alternative is. The U.S. stands to gain a great deal in concessions from the U.K. by making this change through a treaty, rather than unilaterally by separate legislation. The NAM feels that the treaty is a proper vehicle for this legislation, especially in light of the benefits which would otherwise not accrue.

It is then, the position of the NAM that this treaty, as proposed, is in the best interests of the United States economy. The benefits to be gained, both by U.S. investors and corporations, and by the U.S. Treasury far outweigh any negative impact alleged to result from Article 9(4). Indeed, operation of Article 9(4) may spur additional investment, and hence additional tax dollars, in the states now opposing this treaty.

GETTY OIL CO.,
Washington, D.C., July 20, 1977.

Hon. JOHN W. SPARKMAN,
Chairman, Senate Foreign Relations Committee, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR SPARKMAN: The accompanying statement in support of the pending income tax treaty between the United States and the United Kingdom signed December 31, 1975, is submitted to the Committee on behalf of the following California headquartered corporations, who believe it is in the best interest of the United States that the treaty be adopted promptly and in its entirety.

Dart Industries, Inc.
The Fluor Corporation

Getty Oil Company
Santa Fe International Corporation
Security Pacific National Bank
Twentieth Century-Fox Film Corporation
Union Oil Company

Very truly yours,

W. K. WOODSON,
Tax Manager.

Enclosure.

STATEMENT IN SUPPORT OF U.S.-U.K. INCOME TAX CONVENTION OF DECEMBER 31, 1975

INTRODUCTION

The U.S.-U.K. Double Taxation Treaty represents the first completely revised tax treaty with the United Kingdom since 1945. This revision is timely in view of the many changes in both U.S. and U.K. tax laws in the past thirty years, including recent changes in the U.K. income tax laws to integrate corporate and shareholder income taxes.

Not only does this treaty represent a major agreement with one of our closest friends, it also extends the tax benefits of the integrated U.K. tax system to both U.S. individual and corporate shareholders. It sets an important precedent for future U.S. negotiations with member countries of the European Economic Community and other countries as they continue to revise their tax systems to integrate corporate and shareholder taxes as the U.K. has done.

UNITED STATES TREATY POLICY

Excellent policy reasons for ratification exist. The U.S. Treasury for some time has pursued a policy of renegotiating existing tax treaties as well as negotiating new ones. For example, tax treaties are at various stages of negotiation or renegotiation with Brazil, Canada, Denmark, France, Holland, India, Indonesia, Spain and West Germany. The results of these efforts are before the Committee with respect to Egypt, Israel, Korea, the Philippines, and the U.K. The U.K. treaty follows the 1963 model tax treaty of the Organization of Economic Cooperation and Development (OECD) in principle and terminology and a revised treaty recently issued by the OECD. In fact, in May of 1976, the U.S. Treasury first published a model treaty of its own which closely resembles the revised OECD draft. As a member of OECD, the United States would, by ratifying this treaty, demonstrate its desire to follow OECD standards of international taxation embodying principles of fairness, non-discrimination and administrative assistance.

GENERAL EFFECTS OF THE TREATY

The provisions of the treaty are beneficial to U.S. individuals, businesses and the U.S. Treasury. Funds that would otherwise remain abroad will flow back into the United States and the amounts involved can be substantial. A concomitant result of this will be an increase in the capital and tax base of the U.S.

Some of the 29 articles of the treaty are unique. They present reasonable solutions to problems of double taxation and harmonization of tax rules between the U.S. and the U.K. Many of the rules in this treaty will be an important precedent for future negotiations. The purpose of any tax treaty is to insure that residents of the treaty countries are equitably taxed in situations where double taxation may result. This treaty fulfills that purpose. It provides for a detailed allocation of costs and the right to cost sharing for research and development expense. These provisions are meaningful to clarify an increasingly important area of taxation. The Committee may be familiar with the difficulties encountered in making rules for similar allocations under Section 861 of the Internal Revenue Code, the pressures of the Internal Revenue Service on U.S. business to allocate such costs to their foreign subsidiaries, and the reluctance of foreign governments to permit U.S. controlled subsidiaries to deduct such expenses.

The treaty deals extensively with the taxation of personal service income. It will provide for a greater degree of certainty in an area where arbitrary acts of tax authorities have sometimes inequitably affected the income of individual taxpayers, especially artists and athletes.

The treaty prohibits discriminatory taxation by insuring that nationals of the U.S. or the U.K. who are resident in the other country shall not have more burdensome taxes imposed upon them than nationals of that other country under similar circumstances. This fulfills a principal purpose of any tax treaty.

The treaty also resolves an increasing area of conflict with our trading partners by requiring state conformity to the internationally accepted tax rules of the federal government on the allocation of international income among companies in the same corporate group.

Certain of these treaty rules are worth extended comment: the importance of recognition of tax credits for income from the North Sea and the U.K. corporate income tax itself; the meshing of U.S. tax laws with a foreign country that has integrated its corporate and shareholder taxation; and the application of the treaty to state income allocation rules.

FOREIGN TAX CREDIT PROVISIONS

Article 2 recognizes that the British Petroleum Revenue Tax (PRT) is a creditable foreign income tax in the U.S. At first glance, this may appear undesirable from a U.S. revenue standpoint. North Sea oil will make Britain itself self sufficient in oil perhaps by 1980, and will be a major potential source of oil for the U.S. There is a mutual U.S. and British interest in continued U.S. participation in development of the North Sea oil, which would not have been possible to this date without U.S. participation. Recent Tax Reform measures insure that undue foreign tax credits are not available to oil companies, while the treaty will avoid double taxation of the U.S. companies.

It should be noted that the PRT is an additional tax enacted by the British Government *after* substantial investments and oil discoveries were made in the North Sea. This tax puts U.S. oil companies at an economic disadvantage and their tax burden on both sides of the Atlantic increased. Recognizing the creditability of the PRT alleviates part of this burden.

The credit article also establishes tax credit rules with respect to the U.K. company tax itself which is applicable to all U.K. corporations and will affect all U.S. shareholders of U.K. corporations. As described below, the U.K. has substantially altered its corporate tax structure and one of the important questions for harmonization with U.S. rules is whether U.K. taxes are treated by the U.S. as imposed on U.K. corporations or U.S. shareholders in order to apply our basic foreign tax credit rules. The present situation is one of administrative uncertainty, potentially affecting all U.S. investment in the U.K. This uncertainty will be resolved by the treaty coming into force. Under a prior U.K. law, a similar interpretive problem arose, which led to litigation and a Supreme Court decision on the method of application of the U.S. foreign tax credit, with final resolution coming only through modification of the effect of that decision by an amendment to the then existing treaty with the U.K. The pending treaty will avoid such confusion by setting guidelines for the tax credit treatment of the new U.K. law.

On the British side, there is an important U.K. tax credit provision in Article 23, providing that U.S. citizens residing in the U.K., who are subject to U.S. tax on the basis of their U.S. citizenship, will be given a tax credit by the British against their U.S. tax liability for their U.S. tax on the U.S. source income—an important relief for U.S. residents in the U.K. in the light of recently increased U.S. and U.K. taxes on U.S. citizens resident in the U.K. Moreover, a protocol specifically eliminates discriminatory tax features of U.K. law in the case of women who are U.S. citizens residing in the U.K.

EXTENSION OF U.K. INTEGRATION TO U.S. SHAREHOLDERS

A substantial direct benefit for U.S. taxpayers and the Treasury Department is contained in Article 10 of the Treaty. This Article provides for a refund of a portion of the U.K. corporate tax to U.S. shareholders of British companies (including U.S. companies resident in the U.K.). Simply stated, this is a direct lowering of the U.K. tax rate on U.S shareholders and will increase U.S. tax

revenues. The annual refund of the tax is certain to be hundreds of millions of dollars, which will be of immediate benefit to the U.S. economy. This was a major issue in the treaty negotiations and, indeed, took several years to resolve.

The principle behind the U.K. concession is a simple one; since 1973, the U.K. grants a refund to U.K. shareholders in order to eliminate the burden of taxing corporate income both at the corporate level and again at the shareholder level. On principles of non-discrimination, the refund or imputation of corporate tax to shareholders should be granted to U.S. shareholders of U.K. corporations. Why then was this such a difficult point of negotiation? First, the British tax reform was structured in part to attempt to avoid this concession to the U.S. Indeed, in 1971 the U.K. Select Committee, which recommended legislative changes that favored domestic U.K. investors over foreign investors, said in its report: "the double taxation agreement [between the U.S. and the U.K.] might be drawn so as to mitigate this effect but certainly an imputation system strengthens the hand of U.K. negotiators." *U.K. Select Committee on Corporation Tax*, HMSO, 1971, paragraphs 12–15. Second, even if the U.K. had wanted to act unilaterally to prevent discrimination against U.S. investors, the U.K. was faced with the precedent of France. In the 1967 income tax treaty between France and the U.S., France refused to extend its imputation system to U.S. corporate investors despite the strenuous efforts of U.S. treaty negotiators. Moreover, in the summer of 1975, the Commission of the European Economic Community (EEC) issued a draft directive proposing adoption of imputation systems by all member countries of the EEC and extension of benefits to all residents of the Common Market. For Britain, the U.S. demand to extend the tax benefits to all U.S. investors in the U.K. would place the U.K. out in front of the entire EEC in its dealings with non-residents and create a precedent for the entire community. We must assume the U.K. did not ultimately make its concessions without consultation with its Common Market members. The concessions by the U.K. on this issue are of vital precedential value.

At this moment, the same issue is the subject of current negotiations with France and with West Germany (which has adopted an imputation system effective January 1, 1977) and with Canada, which has a shareholder tax credit limited to Canadian residents. U.S. Treasury officials have indicated this is the one remaining major issue in renegotiation of a comprehensive revised income tax treaty with Canada. It should not go unremarked that U.S. investment in Canada, Germany, France and the U.K. represents 45 percent of the value of all U.S. corporate overseas investment.

The importance of the issue at hand was clearly recognized by members of a House Ways and Means Committee Task Force on Foreign Source Income, appointed to consider major issues in taxation of foreign source income during deliberations on the Tax Reform Act of 1976. In filing its report, the members inserted the following statement in the Congressional Record of March 9, 1977:

"Subsequent to the last meeting of the task force, it came to our attention that the effect of the integrated tax systems of certain foreign countries may be to discriminate against investment in those countries by United States persons as compared with similar investments by their own residents. Our system is not integrated—that is, it does not afford individual shareholders a credit against their personal income tax on dividends for taxes paid at the corporate level. Accordingly, when attempting to redress this discriminatory effect by tax treaty, the United States is frequently in an unequal bargaining position. We are greatly disturbed about this matter, and we recommend that the Ways and Means Committee focus its attention on appropriate steps to respond to this discrimination, including if necessary the possibility of amending section 896 to permit retaliatory action in the case of countries which in this respect discriminate against U.S. shareholders.

"The United States has recently been negotiating with a view to adapting tax conventions to reflect the integrated tax systems of such countries as France and Germany. Those countries integrate corporate and personal income taxes by refunding to resident shareholders part or all of the corporate tax paid with respect to distributed profits.

"Where a credit with respect to the foreign corporate tax is granted only to residents of the foreign country and only in respect of dividends paid by corporations resident in that country, the corporate tax burden increases in direct proportion to the foreign corporation's degree of United States ownership.

The discrimination against American investment that results when an integrated system gives refunds or credits only to its resident shareholders can be quite substantial.

"* * * *

"We are greatly concerned about this situation and will, unless a mutually satisfactory resolution is forthcoming, recommend that the committee consider legislation which would give the President authority, if he determines that a foreign country does not accord investment by United States residents treatment comparable to investment by residents of that foreign country, to tax investment in the United States by nationals or residents of that country at comparably discriminatory rates."

Clearly ratification of the U.K. treaty and subsequent negotiations based on that precedent is a more desirable result than resort to retaliation.

APPLICATION OF THE TREATY TO STATE ALLOCATION RULES

International tax treaties are entered into in the interest of furthering freedom of trade and investment by harmonizing tax rules. They are established by sovereign nations keenly aware of assuring their fair share of revenues from multinational businesses. You have been urged by various states to reject this treaty as an unwarranted intrusion on state taxing powers and their rights to tax foreign multinational businesses having contacts with them.

The states' objections to the treaty center around Article 9(4) which is alleged to have an adverse impact because of a loss of state revenues. Article 9(4) provides that neither the U.S. nor the states can apportion the world-wide income of multicorporate groups by including the income of foreign corporations controlled by residents of the United Kingdom in an apportionment formula unless such corporations are engaged in business in a state of the United States. The federal government and the states can, of course, continue to tax the income of any corporation operating in a state and can adjust the accounts of related corporations to properly reflect income and expenses. However, the income and expenses of the corporations controlled by U.K. residents and operating in the U.S. are to be determined by the federal government and by the states under a standard of arm's length dealing by independent parties. These rules apply reciprocally to taxation by the U.K. and its political subdivisions.

STATE TAXING POWER AND TREATIES

It is argued that Article 9(4) goes beyond the treaty powers of the U.S. because it unilaterally reduces the base upon which states can impose their income taxes.

However, in California, it has been clearly held that a treaty can lawfully limit an individual state's taxing powers.

In *Scandinavian Airlines System vs. Los Angeles (56 C 2d 11, 363 P 2d 25)*, the California Supreme Court concluded that United States treaties with Sweden prohibited local property taxation in the United States as related to airplanes used in Los Angeles, but owned, based and registered in a foreign country. The Court thus held an apportioned ad valorem property tax invalid because of the U.S.-Sweden tax treaty.

In reaching its decision, the Court found that Article XIII of the Tax Treaty provided that "taxes on property or increments of property . . . may be levied only in that contracting state which is entitled under the preceding article to tax the income from such property." The treaty also provided that income from aircraft shall be taxable by the nation of registry.

The Court's opinion is instructive. It said "International Treaties . . . represent executive action, and although approved by the Senate (U.S. Const. Art. II, Sec. 2, Clause 2) are not the Congressional action contemplated by the Commerce Clause (Art. I, Sec. 8, Clause 3). But they are equally binding on the states. Treaties are the supreme law of the land, binding upon the courts of every state (Art. VI, Clause 2). If the tax hereunder review is repugnant to the terms of any such treaty, the tax must be declared invalid."

This California authority, itself, disposes of the argument that the federal government cannot limit state taxing power. It is clear that under the treaty power granted to the federal government, state tax laws are to conform to federal standards and this is recognized by the state.

DESCRIPTION OF THE UNITARY APPORTIONMENT SYSTEM

Despite the resolution of the question of Federal treaty powers the main argument of those states opposing the treaty still persists that ratification of the treaty will reduce state revenues. First, it should be made clear that we are actually talking about a very limited number of states out of all the states. Second, even if some present revenue practices are affected, for the reasons hereinafter detailed, there is no reason for a few states to engage in practices inconsistent with the accepted international rules to which the U.S. and other nations subscribe. Thus stated the issue is whether certain states should continue to allocate taxable income by the apportionment of the incomes of separately incorporated members of foreign multinational groups when those members conduct no business in the state or even in the U.S. A few states are trying to do this. They require reporting of world-wide operations in order to measure the part of a foreign corporation's consolidated net income that is subject to tax in the state. Unfortunately, they are using a system which has been developed for application to domestic corporations doing business in several states: the unitary apportionment system.

The few states which employ the world-wide unitary apportionment are principally, California, Oregon and Alaska, though the laws of certain other states provide for selective application of some elements of unitary apportionment. We are unaware of the application in practice in these other states of such rules to foreign owned parent companies and foreign affiliates that conduct no business in the U.S. Specific details of the unitary apportionment system differ from state to state. The California system illustrates the impact of these rules on international business activities.

Where a single enterprise is doing business both inside and outside California, income is apportioned to California under the traditional three-factor formula (payroll, property and sales). However, where an enterprise doing business in California controls other corporations, is itself controlled by another corporation, or is related to other corporations by virtue of common ownership, and where the degree of common ownership or control is over 50 percent, California requires the controlled group to file a combined report of the group's world-wide income. If control is in fact exercised, even in the absence of the requisite 50 percent stock ownership, an affiliate may be included in a unitary group.

A combined report is required regardless of whether the parent company or brother-sister companies do business in California so long as the group constitutes a "unitary business" under California's rults. A unitary business has separately been described by administators as not admissible of precise definition. It is found to exist where there is (1) a unity of ownership (common ownership); (2) a unity of operation as evidenced,, for example, by central purchasing, advertising, accounting and management, and (3) a unity of the use of its centralized executive force and general system of operation. Alternatively, a business will be treated as unitary if the operation of that part of the business carried on in the state is dependent on, or contributed to, that part which is carried on outside the state. The extraordinary sweep of this definition is evidenced by the recent *Beecham* case in California (March 2, 1977), where the California Franchise Tax Board cited the failure of a U.K. company to prevent a public stock offering by its U.S. subsidiary, thereby diluting the U.K. company's stock ownership, as an example of "intercompany financing" justifying a requirement of combined reporting of the income of the parent and the U.S. subsidiary.

The burden of proof that a particular entity under common control is not part of a unitary group generally rests with the taxpayer.

The combined report is, in effect, a consolidated return of the controlled group's world-wide income, although there may be separate returns for each members of the group. California apportions income to the state on the basis of the proportion which the California assets, sales and payroll bear to the total world-wide assets, sales and payroll of all the related companies.

In the context of multinational business operations, the California tax authorities do not limit the requirements of a combined report to enterprises which are California or United States controlled. For several years now, affiliated groups or corporations having a foreign parent and a California subsidiary have been required to file a combined report where the business has a "unitary" character.

Under any reasonable concept of source of income rules, the world-wide unitary apportionment method as applied by California authorities can and does result in the taxation of foreign source income of foreign corporations that is unrelated to California except through common ownership.

It should be noted that while the California tax authorities have vigorously advocated the world-wide approach to other state tax administrators, there remain significant questions in California as to how far the California rules will be applied by California courts.

In *Chase Brass and Copper Company vs. Franchise Tax Board* (10 Cal. App. 3rd 496), the California appeals court excluded the Chilean mining operations of a separate subsidiary of a U.S. controlled group from combined reporting. While the issue there was the unitary nature of a business, this holding in some respects goes further than Article 9(4) of the treaty which limits apportionment only in the case of U.K. controlled corporations. The effect of Article 9(4) could be said to limit the states in this context to what they ought to do in the absence of a treaty. Nevertheless, California tax authorities continue to construe the definition of a unitary business very broadly, so that related entities which appear to be independently engaged in very different kinds of activities are aggregated into a unitary business and must, therefore, be included in a combined report to the tax authorities.

CONSISTENCY OF UNITARY APPROACH

The unitary theory could be advocated as an effort to approximate an allocation that would be obtained under an arm's length approach. If this is correct, the revenue loss asserted by the state of California clearly exceeds the revenue to which the states are entitled. California should obtain the same revenues under an arm's length approach.

If the theory behind the unitary approach is to seek a "fair" allocation of income, then it admittedly departs from the income that would be determined by market factors. The implication of this should be understood. The arm's length approach does not seek to correct any unfairness that the market might creat. Thus, a dominant manufacturer might be able to impose high prices on sales to independent distributors or impose lower purchasing prices on suppliers. One can ask why one approach, "fairness", is used as to some types of transactions, where there are related entities, and a fundamentally different approach, "arm's length", applied in other transactions, where there are independent businesses. This fundamental question should be answered satisfactorily before individual states claim the right to impose their system on foreign corporations and foreign businesses.

There is the additional conceptual problem in that the unitary system basically disregards the separate identity of a corporation and its shareholders. —a distinction fundamental to the policy of permitting incorporation. This inconsistency between recognition of the separate entity for some purposes and not for others particularly leads to complications in international trade and investment.

In order to have a workable, fair, unitary approach, there must be one authority that determines what the net profits of an enterprise are and the factors that go into the formula for apportionment of those profits and who shall measure them. No such authority or even consensus exists in international tax relations. It is presumptuous for a state of the United States to take that role on itself.

INEQUITIES OF THE UNITARY SYSTEM

A fundamental problem in applying the unitary system is simply, what is a unitary business? When are two companies incorporated in two different countries and perhaps under different chains of ownership, to be considered "unitary"? California has swept aside the original concept that a unitary system applies solely to the manufacture of products in one entity and the sale by a related entity. California considers most multi-corporation groups as unitary, except commonly owned corporations doing business in California, an inconsistent position.

The revenue estimates of the State of California are instructive. The Treasury Department estimates that total state revenue from the taxation of all foreign companies doing business in the United States is approximately $410

million. California claims the denial of using a unitary concept not merely for United Kingdom companies, but for all companies doing business in California would result in a California revenue loss of $125 million. This is 30 percent of the total revenues from taxing foreign income by all the other 44 states that tax corporate income. Either the California estimates are inaccurate or they reflect a wholly disproportionate tax burden on international business. As stated in an analysis published by the Treasury Department:

"According to California tax authorities, the world-wide application of the unitary system produces about $125 million in state tax revenue. The basis of this estimate is unknown, and the estimate itself appears to conflict with the California claim that the purpose of the unitary system is to measure California income, and not to tax foreign source income as defined for Federal tax purposes." Department of Treasury, *Essays in International Taxation* (1976), page 265.

One answer, of course, is that a unitary tax system may result in taxing revenues not generated in the state, and conversely may, because of the arbitrary formula, shelter income that should be taxable in the state. A formula approach may appear to have an ease of administration, but this does not mean that it is an accurate measure of tax liability. Selective enforcement tends to result in its application solely to increase state tax revenues. The uncertainties and potential for taxing unrelated foreign income of a foreign controlled corporation can have an adverse impact on the industrialization of a state and foreign investment in the United States itself.

ADVERSE EFFECT ON DOMESTIC INVESTMENT

Clearly the potential for an adverse investment impact in a state should be the concern of the state. As in many situations, it is not likely to be the concern, however, of the tax authorities who view their functions as maximizing tax revenue from potential taxpayers. Some state authorities have had the wisdom to review their tax policy in the light of its impact on business investment and the effect on domestic jobs. Thus, the state of Illinois withdrew from the Multi-State-Tax-Compact after determining that a unitary tax system would deter investment in an industrial state by out-of-state enterprises.

The practical consequences for investment are clear: the result will be to discourage foreign investment and lead to liquidation of units with average profitability. Viewed from the foreign investor's perspective it is counterproductive to contemplate investment under a rule that, to the extent you increase the number of jobs and salaries in your U.S. subsidiary, a greater portion of the income earned by the parent at home and by other foreign affiliates will be allocated to and taxed in the U.S.

However short-sighted a state may be, there is a national interest in providing rules that do not deter productive foreign investment from coming into the United States and creating jobs and production in this country.

FOREIGN GOVERNMENT REACTION

In recent years, a number of treaty partners of the U.S. have raised the specific issue of California's application of its unitary apportionment system to multinational corporate groups based in their countries. They have pointed out that U.S. income tax treaties clearly provide that one Contracting State may not tax the business profits of an interprise which is a resident of the other unless the income is attributable to a permanent establishment in the first Contracting State. The California system is viewed as taxing profits which are earned outside California which are not attributable to a permanent establishment located in California. Foreign governments have also pointed out the severe administrative burdens which compliance with unitary apportionment systems imposes on their corporations.

There is a serious potential problem as well. The use of sweeping unitary tax systems by a few states which disregard the separate incorporation and operation of businesses related through stock ownership may well become an attractive precedent to be seized upon by certain developing countries in an effort to allocate additional income away from the industrial nations through formulas favoring the developing countries.

ANALYSIS OF ARM'S LENGTH FORMULA

Those few states which have applied the unitary system to foreign affiliates have seen it as a logical extension of the standard use of the three factor formula they apply to domestic corporations. It is also viewed as a means of dealing with efforts by groups of related corporations to manipulate income and expenses to the detriment of the state treasury. This is a legitimate concern. It is also a concern of the Federal Government. The treaty deals explicitly with this issue both for the Federal and state governments. Paragraph 1 of Article 9 provides for the adjustment of accounts between related persons to reflect the income and expense which would be recorded if the related persons were dealing at arm's-length as independent entities and nothing in the treaty prevents the Federal or state governments from making the arm's-length adjustments.

Since most taxing jurisdictions in the world use an arm's-length standard to define the taxable income of an entity in a corporate group, the use of a different method in the international context by one jurisdiction will often lead to double taxation.

The principle of an arm's-length standard for taxing inter-country income has been affirmed by the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development (OECD) consisting of 25 countries, including Western Europe, Australia, Canada, Japan, and the United States. The principle is embodied in the model income tax convention of this Organization and in many hundreds of bilateral income tax treaties entered into among members of the Organization and with other countries throughout the world. It is the basic rule in the 37 tax treaties of the U.S. now in force. The OECD treaty specifically applies this rule to subsidiary levels of government.

Probably, the most dramatic acceptance of the arm's length principle, however, has been that of the developing countries of the world, who are ordinarily extremely jealous in safe-guarding their revenues and in their concern about exploitation by multinational enterprises. The 1974 Guidelines for Tax Treaties between Developed and Developing Countries was prepared by the group of experts on tax treaties established by the Secretary General of the United Nations pursuant to a resolution of the Economic and Social Council. The Guidelines summary states:

"The basic rule applied in international law and in treaties, as crystallized in the OECD Draft Convention and reaffirmed by the Group of Experts, is that the profits of the various parts of an enterprise (i.e. branches or subsidiaries, in relation with the home office) should be those which would result if the various units were dealing with each other at arm's length, as wholly independent enterprises, and,therefore, would charge to each other prevailing market prices."

The federal government of the United States uses as its tool in enforcement of inter-company pricing the provisions of Section 482 of the Internal Revenue Code:

"Sec. 482 [1954 Code]. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

California has virtually identical statutory provisions in section 17615 of the California Revenue and Taxation Code:

"§ 17615. ORGANIZATIONS, TRADES OR BUSINESSES OWNED OR ORGANIZED BY SAME INTERESTS

"In any case of two or more persons, organizations, trades, or businesses (whether or not incorporated, whether or not organized in this State, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such persons, organizations, trades, or businesses, if it determines that such distribution,

apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons, organizations, trades or businesses."

Paragraph 1 of Article 9 of the U.S.-U.K. Treaty assures both the Federal Government and the state of California of their right to invoke those provisions:

"(1) Where an enterprise of a contracting State is related to another enterprise and conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any income, deductions, receipts, or outgoings which would, but for those conditions, have been attributed to one of the enterprises but by reason of those conditions have not been so attributed, may be taken into account in computing the profits or losses of that enterprise and taxed accordingly."

THE STATE ADMINISTRATIVE ISSUE

Recognizing that in some cases administrative resources available to state governments may not permit them to make the same kind of intensive transfer price investigations that the Federal tax authorities are able to make, it should be emphasized that individual states can enlist the cooperation of the Internal Revenue Service in investigating those cases where related companies may not be pricing according to an arm's length standard.

The Internal Revenue Service has recently concluded 31 new agreements on coordination of tax administration with the various state agencies. As indicated in the news release by the Internal Revenue Service "the agreements are intended as a means of increasing Federal/state cooperation in various areas of tax administration such as cooperative audits. . . ."

Suggestions by state authorities that they are unable to audit or apply inter-company pricing standards and therefore must resort to the over-reaching unitary method for international transactions are without credibility. No corporate taxpayers with any significant overseas activities go unaudited by the Internal Revenue Service.

Perspective must be maintained as to the size of the alleged problem. In the most recent U.S. Treasury Department Statistics of Income, federal income tax returns were filed by 1,733,000 active corporations doing business in the United States. Of this number only 6,000 claimed foreign tax credits for income from foreign sources. An even smaller number are owners of foreign subsidiaries. International investment and trading of any significance is carried on by a limited number of corporate taxpayers, all of whom are subject to close audit by the Internal Revenue Service and zealous scrutiny of inter-company transactions.

Indeed, if a state cannot verify inter-company pricing transactions, one can only ask how can a state verify income statements and reports prepared by foreign corporations organized and operating separately in countries throughout the world and with no presence in the state.

COMPARISON OF ARM'S LENGTH AND UNITARY APPORTIONMENT

The use of the unitary apportionment system is a highly imperfect substitute for the arm's length standard. Implicit in the unitary system is the assumption that profit rates in different units of a corporate family, engaged in different activities and in different locations, are always the same. This is clearly not the case. To the extent that it is not the case, the unitary system will misallocate income. If a multinational group is involved these differences are likely to be accentuated, as compared with a domestic group. Whenever profit rates are higher in foreign affiliates than in domestic activities, the unitary apportionment system allocates too much income to the domestic member or members of the group. The result is the equivalent of taxation by U.S. government subdivision of the foreign income of a foreign corporation and the object of legitimate protest by foreign governments.

To the extent that economic theory suggests that profit rates in different parts of a single corporate group should tend in the long run toward equality, this may occur with respect to return on capital. However, unitary formulas use three elements property, payroll and sales—and there is no basis for assuming equality of rates of return with respect to sales or labor costs.

Misallocation of the tax base under the application of unitary apportionment to foreign corporation can arise for several reasons. Labor costs vary more substantially among countries than among regions in the U.S. In many instances, the foreign labor cost element in the formula will probably be lower than the U.S. labor cost. This will result in the apportionment of a disproportionate amount of income to the state in the U.S. applying the formula. Similarly, substantial differences in the cost of plant, equipment, inventory and other property distorts the property factor. Such distortions are further increased by fluctuating conversion rates of foreign currency.

Another problem of comparability arises out of California's use of before-tax income as the basis for apportionment. When dealing with a group of U.S. firms, the relationship of pre-tax profits among different firms in a group is not likely to be very different from the relationship of after-tax profits. When the firms in the group are located in and are subject to tax in different countries this is less likely to be the case. The tax burden inserted between pre-and post-tax profits may be very different and distort the relationship between the three elements in the formula. For example, levels of taxation in oil producing countries vary widely and tend to be far higher than in the United States. This distorts the relationship between before-tax income which in turn distorts the amount of income apportioned by means of the formula.

In contrast to the arbitrary application of a mathematical formula unsuitable for comparing dissimilar international factors, the arm's length approach of Section 482 of the Internal Revenue Code and of Section 17615 of the California Revenue and Taxation Code provides the fairest measure of the contribution which activities in each country make to the generation of income; namely, the test of the market place.

TAXPAYER COMPLIANCE BURDEN

A major problem in the application of unitary apportionment systems to multinational corporate groups arises out of the kinds of information required by the state taxing authorities and requirements as to the form in which it is required to be submitted. A great deal of information is required merely to determine whether any particular member of the corporate family is a part of the unitary group. Once that determination is made, additional financial and operating data from each affiliate must be included in the combined report of the group.

Where members of the group, and particularly the parent corporation are located abroad, much of this information is either difficult or impossible for the taxpayer to obtain. Such information may not be available to U.S. subsidiaries. In some cases providing the required information would violate corporate policy or foreign laws. Foreign parent corporations find it extremely burdensome to submit all of their books and records concerning all of their world-wide activities in a form satisfactory to the taxing state. This is especially true when only one of a large number of their affiliates does business in the state and the books and records are kept in different languages, different currencies and according to different sets of accounting rules. As a result foreign parents corporations have refused to supply the requested information.

It has been reported that in one case, because a single affiliate was doing business in California, a foreign parent corporation was asked to file a state tax return for each of four years for each of its 400 world-wide affilated corporations—1600 tax returns in all. Substantial adjustments would have been required to the books of most of these 400 companies in order for the returns to conform to the Franchise Tax Board's requirements. The burden would be intolerable if each state imposed such requirements.

If the necessary information is not provided by the taxpayer, the state taxing authorities will use whatever information they can obtain from public sources. The result may be tax liability calculated on an arbitrary and unfair basis.

The basic fact to note, is that combined reporting on an international scale is an immense burden for companies that have no other reason to prepare such information. For purposes of the California rule, that information would include:

(1) The cost of all property owned or leased by the corporate group world-wide and the property owned or leased in California (the "property factor");

(2) The amount paid to the corporate group's employees world-wide and the amount paid to California employees (the "payroll factor");

(3) The sales income of the corporate group world-wide and the sales in California (the "sales factor");

(4) The net taxable income of the corporate group world-wide based upon California's rules for determining taxable income.

FEDERAL GOVERNMENT REACTION

State taxation of foreign corporations is receiving increased international attention and has been viewed with concern at the national level in the U.S. The effect of the system on future investment decisions by foreign investors should be taken into account by the affected states and by the federal government. The long run adverse impact of such systems is likely to be much more significant than short term opportunities to pick up revenue.

Legislation was proposed in the House during this past Congress, which would be similar in effect to the U.K. treaty provision, except that it would exclude all foreign corporations from state unitary tax bases. The Amendment was referred, along with several other legislative proposals affecting the taxation of foreign income, to a special Task Force of the Ways and Means Committee on Foreign Source Income. After extensive examination of this issue, including debate before the Task Force by state tax authorities from Oregon and California, the Task Force recommended that the states be precluded from taxing foreign income of foreign affiliates of corporations doing business within the states until such time as that income is subject to federal income tax. This recommendation was based on the consideration that as long as the U.S. government imposes tax on income allocable to the U.S. on one standard, there is absolutely no justification for a few states of the U.S. to do otherwise:

"The tax force makes the following recommendations with respect to State taxation of foreign source income:

"(1) Income of foreign affiliates not subject to Federal income tax.—It is recommended that the States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income is subject to Federal income tax.

"(2) Income of foreign affiliates subject to Federal income tax.—It is further recommended that no limitation be placed on the power of the States to apply the three-factor formula on a domestic basis, under the unitary method or otherwise, to income of foreign affiliates which had been excluded under paragraph (1) above if and when such income becomes subject to Federal income tax." Committee on Way and Means, U.S. House of Representatives, "Recommendations of the Task Force on Foreign Income", 95th Cong. 1st Sess. March 8, 1977, p. 30.

APPLICATION OF U.K. TREATY 9(4) PROVISION

The provision of the present treaty and protocol is limited to corporations controlled by our U.K. treaty partners. It is drafted reciprocally and is applicable to both the Contracting States and to their subsidiary levels of government.

In those cases where the provision applies to a state, the treaty provides that a state in assessing the income of an enterprise doing business in the state, may not take into account any income or expenses of a related company which is related to the U.K. enterprise.

However, this restrictive rule will apply only if the following conditions are met:

1. The enterprise doing business in the state must be either a resident of the U.K. (*i.e.* a branch of a U.K. company operating in the state) or be controlled, directly or indirectly by a U.K. resident (*ie.* a U.S. corporation which is a subsidiary of a U.K. corporation); and

2. Where the U.K. resident is a corporation, such corporation must be neither controlled by a U.S. corporation nor by a corporation which is a resident of a third state.

Further, no U.K. or third country enterprise which is related to a U.S. subsidiary doing business in the state would be excluded from unitary apportionment calculations under the treaty if that enterprise is controlled by the U.S. subsidiary.

SUMMARY

It should be sufficient here to reiterate what history and legal precedents tell us is the basic tax treaty position of the United States. It is that a business enterprise should be taxable in a country on its business profits only if it carries on business in that country through a branch or similar permanent establishment. This principle is followed in all income tax treaties of the United States. Any state's world-wide application of its apportionment formula is inconsistent with this principle because it taxes foreign income which is normally not the subject of federal taxation.

Article 9(4) of the new U.S.-U.K. tax treaty is therefore clearly a reasonable effort to correct justifiabe complaints concerning state taxation of foreign income.

All recent treaties prohibit tax discrimination by the states against our foreign partners. Whether or not state tax systems are theoretically suitable for multi-national activities, it is disruptive of tax relationships with other countries to have some individual states applying burdensome rules inconsistent with U.S. rules and international practice. Also, it will eliminate the need for U.K. companies to request Competent Authority to eliminate this discriminatory taxation. The United Kingdom is one of a number of foreign governments which have brought this to the attention of the Treasury and have sought relief in the treaty.

We should expedite ratification of this tax treaty. It is in line with the precedents of previous treaties. It creates an equitable basis for income taxation between both countries, and adopts a limited and reasonable solution to the problem of the state taxation of foreign income. It fosters a greater in-flow of dollars in the U.S., increases our revenue base, and strengthens our competitive position overseas. In light of the negotiations and efforts of both countries in drawing up and agreeing to its many provisions, the treaty must be ratified in an expeditious manner.

Our great risks are that failure to approve this treaty in full will lead to a breakdown in the efforts now under way to harmonize taxation of international investment under principles of non-discrimination and that failure to limit the over-reaching and burdensome income tax procedures applied by what are now only a handful of states may lead to a proliferation of such practices, perhaps on a competitive basis, imposing a substantial state barrier to foreign investment and the creation of new jobs in this country.

LAW OFFICES,
KROLL, EDELMAN, ELSER & WILSON,
New York, N.Y., July 19, 1977.

Hon. JOHN SPARKMAN,
Chairman, Committee on Foreign Relations, Dirksen Office Bldg., Washington, D.C.

Attention: Michael Glennon, Esq.

Re Hearings on United States-United Kingdom Income Tax Treaty, July 19–20, 1977.

MY DEAR SENATOR SPARKMAN: Our law firm represents a number of insurers domiciled in the United Kingdom, which insurers have a great interest in the hearings to be held on the United States-United Kingdom Income Tax Treaty on July 19th and 20th.

In this regard, we submit herewith in triplicate a written brief in support of ratification of the Treaty on behalf of our clients. We respectfully request that you bring this material to the attention of your Committee for consideration.

We thank you for your cooperation, and we remain

Yours very truly,

EDWARD M. CAMERON, III.

Enclosure.

Income Tax Treaty between the United States and the United Kingdom

INTRODUCTION

This brief is presented in support of ratification of the United States-United Kingdom Income Tax Treaty which is now being considered by the Committee on Foreign Relations of the United States Senate.

The law firm of Kroll, Edelman, Elser & Wilson represents nine English insurance companies which, due to the current tax situation in this country affecting them, would be beneficially affected in their tax status by the ratification of the new treaty. The following is a brief exposition of the situation as it applies to these companies today, together with a description of the changes which would be brought into play by the new treaty, changes which our clients feel are sufficient to warrant their support of ratification of the treaty.

Typically, our English clients operate as property/casualty insurers in the United States market under the denomination "non-admitted insurers," conducting their business from one or the other of two bases.

First, an insurer may operate as a reinsurer in the non-admitted market. In this way it may underwrite or reinsure portions of the risks assumed by other insurers who are writing primary, or direct, insurance in the United States market.

The second method of operation is as a "trust fund alien non-admitted insurer," under which arrangement the insurer would underwrite directly risks originating in this country. Normally under this method the alien or overseas company will make a trust deposit with a United States bank, member of the Federal Reserve System, of an amount of money sufficient to enable the company to obtain non-admitted or "surplus lines" eligibility in those states that recognize and will grant such status. The minimum trust deposit made by our clients who have established trust funds in this country has been $500,000, and some have deposited as much as $1,250,000. A trust fund in the latter amount will generally meet the monetary requirements for eligibility as a non-admitted alien or overseas insurer (and thus for all lines of insurance as a surplus lines carrier) in most states of the Union.

The National Association of Insurance Commissioners periodically publishes a list of approved trust fund insurers and reinsurers, and, as of July 1, 1977, there were 73 alien trust fund fund carriers and 34 alien reinsurers listed as approved by the N.A.I.C. The trust fund deposits are normally made for the benefit of policyholders and creditors of the company in the United States.

Although the making of a deposit in trust is the normal method of operation for an alien insurer operating in the United States market, and our clients who have chosen to write primary insurance in this country have made trust deposits, the Internal Revenue Code speaks to the placement of insurance on United States risks with overseas companies regardless of whether or not any trust deposit has been made.

Section 4371 of the Internal Revenue Code imposes on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer upon a United States risk a tax at the rate of four cents on each dollar or fractional part thereof of premium charged as to primary insurance, and one cent on each dollar or fractional part thereof of the premium charged on a policy of reinsurance covering any such policy of primary insurance.

Since this is an excise tax and is imposed upon premiums paid by a United States insured to a foreign insurance company, this levy has been held separate and distinct from the provisions of income tax treaties negotiated between the United States and many of the major industrial countries of the world, such as the United Kingdom. Thus, although alien companies, in order to remain competitive in the U. S. market, have had either to absorb or directly pay this tax over the years, they have because of the statutory language received no exemption or other relief under existing tax treaties, and have been subjected to a potential burden of taxation in this country and in their home country with the added burden that the excise tax is payable on the premiums whether or not any profit is made on the actual business underwritten.

Thus, the English insurers, in order to remain competitive, oftentimes must absorb the four percent tax in the case of a primary placement (or a one percent tax in the case of reinsurance), and in addition must face taxes at home.

The typical English insurance company is taxed at home on a profits basis of 52 percent of underwriting profit plus investment income less expenses, whether from foreign or domestic sources. Our clients feel that it is an unwarranted burden on them, when they help to provide a market for insurance in this country, to be faced with a burden of a four percent excise tax, regardless of profit or loss on the business, in addition to the 52 percent profits tax payable at home.

We note that the Income Tax Treaty presently in effect between the United States and the United Kingdom contains no provision under which our English clients could directly avail themselves of the privilege of avoiding the excise tax levied under Section 4371 of the Internal Revenue Code.

The Treaty provides that its subject matter (as to United States taxes) shall be the Federal income taxes and any other taxes of a substantially similar character imposed subsequent to the date of signature of the Treaty (Article I of the in-force Treaty). The tax on insurance premiums has not been termed an "income tax" for treaty purposes and, although it could easily be described as an income tax or a tax of "substantially similar character," it predates the present convention.

It may be presumed that the present Treaty is calculated, in part at least, to avoid double taxation of alien entities in the area of the 30 percent withholding tax imposed upon U. S.-source income by Section 881 of the Internal Revenue Code, a tax legally imposed on the alien recipient of the U. S.-source income. The tax on insurance premiums, although of the same effect as an income tax and in fact usually "paid" by the alien insurer which absorbs it as a convenience to the customer, is termed by the Internal Revenue Code an excise or documentary stamp tax, and the burden of payment of the tax is laid by the Code (Section 4374) upon the person "to or for whom or in whose name" the policy is issued or "any solicitor or broker acting for or on behalf of such person." (For an exposition of the mechanics of this, we commend to your attention the excellent article on the excise tax on foreign insurance written by Messrs. Gerald I. Lenrow and Thomas St. G. Bissel of Coopers & Lybrand which appeared in the May 1977 edition of *Best's Review*, Property/Casualty Edition, one of the premier journals of the insurance industry.)

The treaty under consideration by your august Committee, however, contains a provision in article II which would effectively waive the excise tax as applied to our English clients.

Article 2 provides that the treaty shall apply to taxes on income imposed by each "Contracting State" and in particular shall apply to "the tax on insurance premiums paid to foreign insurers" [Article 2(2)(a)].

Article 7(1) goes on to provide that "the business profits of an enterprise of a Contracting State shall be taxable only in that state, unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein."

The question of "permanent establishment" is pertinent in this regard because our English clients do not carry on business in this country by means of a permanent establishment.

Article 5 refers to permanent establishment and defines it as follows:

"A person acting in a contracting state on behalf of an enterprise of the other contracting state—other than an agent of an independent status to whom Paragraph (5) applies—shall be deemed to be a permanent establishment of the enterprise in the first mentioned state. If such person has, and habitually exercises in that state, an authority to conclude contracts in the name of the enterprise . . . ."

Paragraph 5 of this Article 5, referred to above, provides that an enterprise of a contracting state shall not be deemed to have a permanent establishment merely because it carries on business through a broker, general commission agent, or any other agent of independent status.

Our clients maintain no offices in this country and act only indirectly through insurance brokers or other representatives of independent status. They do not act through agents with any authority to conclude contracts in their name and they therefore do not establish permanent establishments in this country.

It would seem clear, therefore, that under the wording of the new treaty our clients would be taxable only upon business profits from this country in the United Kingdom, and not here, and that it is the intent of the treaty that the excise tax levied under Section 4371 et seq. of the Internal Revenue Code shall no longer apply to those parties which are covered by the terms of the treaty.

We therefore submit that the excise tax which has been and is, under current law, levied upon premiums paid to English insurance companies in this country is an unfair tax in that it is in fact an income tax but is payable whether or not there is any profit on the underlying business, and it is indeed normally paid by the insurers rather than by their insureds, and since under these circumstances our clients are subjected to taxation again on the same money in the United Kingdom due to the income taxes levied over there, we would like to urge that your Honorable Committee give serious thought to the early ratification of the treaty, and thus to the lifting of his double taxation burden from the shoulders of the English insurers.

On behalf of:

AA Mutual Insurance Association Ltd.,
85 Great Eastern St.,
London EC2A 3PS, England.
British National Life Insurance Society, Ltd.,
Framlington House, 5-7 Ireland Yard,
London EC4V 5DH, England.
La Concorde Compagnie D'Assurances, S.A.,
37/38 Lime St.,
London EC3M 7LR, England.
Mentor Insurance Co. (U.K.) Ltd.,
Third Floor, Forum House, 15/18 Lime St.,
London EC3M 7BB, England.
Minster Insurance Co., Ltd.,
Minster House, Arthur St.,
London EC4R 9BJ, England.
Overseas Union Insurance, Ltd.,
85 Great Eastern St.,
London EC2A 3PS, England.
"The Phoenix" Greek General Insurance Co.,
Baltic House, 27 Leadenhall St.,
London EC3A 1BD, England.
Scottish Lion Insurance Co., Ltd.,
4 Fenchurch Ave.,
London EC3M 5BR, England.
The Sumitomo Marine & Fire Insurance Co. (Europe) Ltd.,
Sedgwick Forbes House, 33 Aldgate High St.,
London EC3N 1AJ, England.

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., August 4, 1977.

Hon. JOHN J. SPARKMAN,
Chairman, Committee on Foreign Relations, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The American Bankers Association respectfully requests the opportunity to express its views with regard to the new United States/United Kingdom income tax treaty, which is currently being considered by the Foreign Relations Committee. The American Bankers Association is the national trade association of the banking industry. Its membership comprises 13,252 banks—92 per cent of the nation's total.

The American Bankers Association favors ratification of the new U.S./U.K. treaty. It views the Treaty as an important measure needed to end discriminatory taxation of U.S. investors and business operations in the U.K. and to restore a measure of tax parity so that American business can effectively compete with local U.K. enterprises. Moreover, the Treaty would also encourage U.K. nationals to invest in the U.S. and to expand commercial business operations in this country, thereby producing a favorable impact on the U.S. economy. It is our view that the Treaty is a mutually beneficial agreement which would result in substantial tax savings for U.S. investors and would increase U.S. tax revenues by reducing the foreign tax applicable to U.K. earnings. It would result in a further stimulant to the U.S. economy by encouraging foreign investors to invest in American business. For these reasons, we urge that the Treaty be ratified by the U.S. Senate.

The ABA is concerned that, due to the controversy regarding the Treaty's restriction of the States' ability to impose a unitary concept of taxation, an

international agreement of far reaching scope and which is vital to our economy will be jeopardized. It is to this issue that this statement is addressed.

It is not our intention to debate the merits of the unitary concept of taxation, nor do we intend to raise any issue as to the right of States to tax persons deriving income within their borders. What is at issue, however, is the ability of the Federal government to effectively negotiate with foreign governments on matters which are of national and international scope and which have a direct impact on foreign and interstate commerce. The treaty-making power of the Executive branch of government is beyond question, subject only to the constitutional requirement of Senate advice and consent. It is equally clear that treaties, upon enactment, become the supreme law of the land, superseding all state law to the contrary. Therefore, the question before this Committee is not whether the Treaty can abrogate state taxing statutes but whether the Treaty, taken in its entirety, is desirable from the standpoint of foreign commerce and the economic well-being of the Nation as a whole.

Despite the protests of certain states over the treaty provision dealing with unitary taxation (Article 9(4)), the issue is of limited impact. There are but a few states which have adopted this type of tax system and it is only in the State of California that a loss of revenue is projected by the opponents of the Treaty. However, the Treaty in no way precludes that State from taxing profits legitimately derived through California activities. The principal objective that the Treaty accomplishes is that it prevents the California tax authorities from imposing burdensome reporting requirements on U.K. multinational corporations, disclosing worldwide financial details, merely because such corporations may have a presence in California. In many cases, the cost of compliance with the existing provisions of California law far exceed any concern as to the actual tax exposure which would result under the provision. In fact, the Treaty does not affect the application of the unitary concept by California to a California subsidiary of a U.K. company which has other U.S. subsidiaries in other states. The Treaty would only bar California from applying its unitary concept to the U.K. parent and its subsidiaries incorporated outside the United States. Nor can the Treaty be invoked by a U.S. multinational to escape California's application of the unitary tax.

For U.K. corporations, the Treaty provision would also provide some additional certainty and predictability as to the tax exposure incident to activities conducted in California by their California subsdiaries. The U.K. parent companies properly regard the California unitary rule as an unreasonable invasion of privacy as well as an undue cost burden which is wholly disproportionate to the tax revenues involved. To meet the requirements of the unitary method, a U.K. parent corporation may be required to restate the tax returns or financial statements of all its non-U.S. companies not only in U.S. dollars but also under California tax rules.

In principle, the provision at issue merely establishes a conceptual equality for the treatment of U.K. multinationals operating in the U.S. with the treatment of U.S. multinationals operating in the U.K. Moreover, the Treaty is consistent with the theory of U.S. tax law, the OECD Model Tax Convention and other existing treaties under which the independent status of the corporate entity is recognized. The same holds true for the theory of taxing locally earned profits through a permanent establishment of a foreign corporation. The profits derived from activities within a host country are taxable. If those profits are not properly reflected, then adjustments must be made for pricing based on an arm's length standard. This mechanism is available to the California tax authorities to assure that it receives its proper share of tax revenues. The controversial provision of the Treaty merely seeks to "harmonize" the tax systems of the State and Federal governments, as they apply to a U.K. multinational parent corporation.

In summary, the ABA views the new U.S./U.K. Treaty as a favorable agreement between nations which will result in substantial benefits to the U.S. and its citizens. For the common good, the public interest must prevail over the slight inconvenience, if any, that might be caused to a few states in the enforcement of their tax laws. Notwithstanding protests to the contrary, California will still be able to collect appropriate tax revenues on arm's length profits derived from activities or properties within its jurisdictional borders. Lastly, if, as has been suggested, the Treaty is amended by reservation to delete Article 9(4), the British Parliament will have to reconsider the Treaty. The likely

result would be the loss of the substantial benefits that accrue to U.S. investors and U.S. parent companies under the present version of the Treaty. In view of the foregoing, the ABA urges that the Treaty be ratified without reservation and without further delay.

Sincerely,

GERALD M. LOWRIE,
Executive Director, Government Relations.

UNITED STATES COUNCIL OF THE
INTERNATIONAL CHAMBER OF COMMERCE,
New York, N.Y., August 1, 1977.

Hon. JOHN SPARKMAN,
Chairman, Foreign Relations Committee, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The United States Council of the International Chamber of Commerce strongly supports the ratification of the Convention Between the United States and the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, as signed on December 31, 1975 and as amended in April 1976, together with the Fiscal Protocol signed by both governments in August 1976 and the Second Protocol which was proposed in February 1977.

The United States Council membership is comprised of most of the major business firms in the United States engaged in foreign trade and foreign operations. It represents American business interests within the International Chamber, which in turn represents the international business community in approximately 60 countries.

I request that this Statement be made a part of the Hearing Record on the matter of the ratification of the U.K./U.S. Convention.

INTEGRATION CREDITS

In our view, this treaty is undoubtedly the most significant treaty to be presented to this Committee for advice and consent in many years. Its significance lies in the fact that the United Kingdom has agreed to extend its integrated tax system to encompass U.S. investors in U.K. companies. Article 10 of the convention provides, in part, that the U.K. Treasury will refund to a U.S. portfolio shareholder (individuals and less than 10 percent corporate shareholders) an amount equal to the full imputation credit which such shareholder would have received had he been a U.K. individual resident (less a 15 percent withholding tax). In addition, Article 10 also provides for the payment of an imputation credit by the U.K. Treasury to U.S. direct investors (10 percent or more corporate shareholders) in an amount equal to one half of the imputation credit which would have been applicable had the U.S. investor been a U.K. resident individual (less a 5 percent withholding tax).

Integrated tax systems allowing an imputation credit for part of the corporate tax to domestic shareholders are being adopted by the major industrialized countries around the world (e.g., Canada, France and Germany) and have been recommended as the preferred method of taxing corporations and their shareholders by the EEC. By its very nature, such a system discriminates against foreign investors because the foreign investor is not allowed an equivalent of such credit. It is thus very much in the interest of U.S. investors and the U.S. Government to attempt bilaterally by treaty to redress this discrimination insofar as it affects U.S. investors. Heretofore, the U.S. treaty negotiators have had very limited success in convincing foreign governments to extend this integration concept to U.S. investors. For example, France extended its *avoir fiscal* imputation credit by treaty to U.S. portfolio shareholders only. Thus, the agreement by the U.K. Government to extend an imputation credit to U.S. direct investors represents a major concession on their part. This concession must be viewed in the light of the magnitude of U.S. direct investment in the U.K., and represents a major breakthrough on the part of the U.S. negotiators. If ratified, the treaty would encourage maximum dividend repatriation to the U.S. with benefits to the U.S. balance of payments.

It should also be noted tha,t in addition to increasing a U.K. direct investor's yield form U.K. investment, the imputation refund feature has the effect of reducing the U.K. effective tax rate on U.K. affiliates of U.S. corporations, with respect to maximum dividend payments, from the statutory U.K. tax rate of 52 percent to a rate of 42 percent. This creates additional tax revenue to the U.S. Treasury in the form of additional tax on U.K. income and a reduction in foreign tax credits. Thus, both the U.S. direct investor and the U.S. Treasury would benefit.

It is noteworthy at this time that the U.S. Government is actively renegotiating existing treaties with several imporant trading partners, namely Canada, France and West Germany. Each of these countries now has an integration system, employing the imputation credit technique. We understand that the negotiators from these countries are strongly resisting our efforts to provide, within the framework of a new treaty, for the flow of integration credits or refunds to U.S. direct investors as agreed with the U.K. Ratification of the U.K./U.S. treaty, extending the U.K. credit to U.S. direct investors, could represent a significant step forward in convincing these countries to follow suit, thereby eliminating discrimination against U.S. direct investment. If the U.K. treaty were to fail ratification, the U.S. negotiators will be weakened in their negotiations with Canada, France and West Germany, who will be strengthened in their resistance.

STATE TAX PROVISION

The provision of the pending U.K. treaty which has received the strongest objection from certain state tax administrations in Article 9(4), which limits the application of the unitary basis of assessment (currently applied on a worldwide basis in three states of the union). Article 9(4) excludes from the state tax base a U.K. parent company and the foreign affiliates of the U.K. parent not controlled through its U.S. subsidiary. It has been made clear that this article will not in any way affect the application of the unitary method to *U.S. controlled* foreign corporations operating in the U.K. Article 9(4) requires that arm's length pricing concepts be applied for state tax purposes in transactions between a state and a non-U.S. affiliate of a U.K. parent company.

It does not appear unreasonable for the U.K. negotiators to desire a provision which is in conformity with accepted international taxation principles. Moreover, this limitation is in keeping with U.S. federal principles whereunder only U.S. activities and operations are relevant in determining a foreign enterprise's U.S. federal tax liability.

Treaties generally are negotiated as a balanced package, resulting from the give and take of negotiations between representatives from two nations with adverse revenue interests in the outcome. We understand that Article 9(4) was insisted upon by the British Government as a *quid pro quo* for their agreement to the extension of the imputation credit to U.S. direct investors. It is entirely conceivable that, if the Senate recommends a reservation with respect to Article 9(4), the British may reconsider their ratification, with the result that the entire treaty may be in serious jeopardy. We submit that this would be a grave loss to the U.S. business community and the U.S. Treasury.

In conclusion then, we strongly support the ratification of this treaty in its present form.

Respectfully yours,

WILLIAM J. NOLAN, JR.,
Chairman, Committee on Taxation.

TESTIMONY OF RONALD L. DANIELIAN, EXECUTIVE VICE PRESIDENT AND TREASURER, INTERNATIONAL ECONOMIC POLICY ASSOCIATION

SUMMARY

This statement will highlight the importance of the universality of double taxation treaties in dealing with the conflicts that exist in international taxation. We support the ratification of the U.S.-U.K. tax treaty with inclusion of Articles 9 and 10 and the extension of certain of its universal features to other

tax treaties. However we are disturbed over the acquiescence of the U.S. Government in accepting departures from this universality under the U.S.-Philippines tax treaty (specifically, Article 9(2)). We would recommend incorporation of the reciprocal exemption normally granted on U.S. shipping and airline income.

The real issue before this Committee is whether these treaties are balanced in their mutual concession and whether they further the foreign policy objectives of the United States in a nondiscriminatory manner. Both the Congress and the Executive have an interest in maintaining an open international investment climate which can benefit the United States through a flow of funds into U.S. industries.

The U.S.-U.K. tax treaty would establish a precedent for dealing with the inherent discrimination caused by foreign country moves to integrate their corporate tax systems. A precedent would be established for negotiating similar tax agreements with other countries (such as Germany or France) which have denied U.S. investors or shareholders the same tax treatment afforded host-country nationals. Thus, the present discriminatory practices will be ameliorated in keeping with the purposes of tax treaties.

The U.S.-U.K. tax treaty maintains a balance of concessions between the conflicting pressures on our states (to continue the unitary formula for state taxation) and the national interest in eliminating double taxation. The financial returns to the United States and probably even to the "unitary tax" states would exceed the claimed loss in tax revenue.

The treaty reaffirms the basic international system of taxation which allows a government to tax only the income generated and received by a person or company within its jurisdiction.

With regard to the U.S.-Philippines tax treaty, a precedent is established for the first time with a sanctioning of host country taxation of shipping and airline income. For 37 years this income has been taxed in the home country under a reciprocal exemption granted in U.S. tax treaties. In the Philippines, for instance, airline taxation on a gross billings concept can lead to double or confiscatory taxation (while the local carrier is not subject to the same taxes). The United States should retain a reciprocal exemption similar to the U.S.-U.K. tax treaties and others like it since 1940.

On a long-term basis, the United States must assess the projected actions in the tax area, whether at home or abroad which will affect our international economic system and foreign economic relations in particular. We must take the initiative to restate and clarify the basic international tax principles through international taxation review and harmonization conferences. We cannot act alone on those tax issues which will directly affect our allies and the world in which we live, for such unilateral action is bound to lead to conflicts between governments.

STATEMENT

The International Economic Policy Association is a Washington-based nonprofit research organization founded in 1957 which has concentrated on the study of public policy issues in the international economic arena. Our studies have included several books on the U.S. balance of payments, surveys of major issues affecting the United States and Western Europe, research on the interaction of oil and other raw materials with foreign economic policy, and analyses of the problems associated with U.S. investments abroad as well as taxation of foreign-source income. While IEPA's members are broadly representative of American industry and we benefit from their professional expertise, the Association does not speak for the particular interest of any one company. We have defined our mission as advocating policies and practices by business concerns and governments that will keep American trade and investments abroad in a state of good health and repute.

This statement will highlight the importance of the universality of double taxation treaties in dealing with the conflicts that exist in international taxation. We support the ratification of the U.S.-U.K. tax treaty with inclusion of Articles 9 and 10, and the extension of certain of its universal features to other tax treaties. Concomitantly, we are disturbed over the acquiescence of the U.S. Government to accept departures from this univertality under the U.S.-Philippines tax treaty (specifically Article 9(2)). The real issue before this Committee is whether they further the foreign policy objectives of the United States in a nondiscriminatory manner.

The advent of the 1970's has clothed international economic relationships in an uncertain environment. Starting with the currency realignment in 1971 through the resource-related problems of September 1973, and the demands of the Third World through the New International Economic Order up to the present day, attacks are being made on international economic activity from all quarters. U.S. business faces a tough challenge in remaining competitive and maintaining its high level return on foreign investments which benefits the national interest and the U.S. balance of payments.

From 1948 through 1976 U.S. direct investment contributed a net $88.7 billion to U.S. foreign exchange earnings. The inflow of this money (over and above outflow for the establishment of U.S. investments abroad) has helped to maintain a certain stability in the purchasing power of the dollar, a rapid decline of which would seriously affect the real income of all Americans and inflation factors for key U.S. industries. With Secretary of Treasury Blumenthal indicating that the United States could face up to a $20-billion trade deficit in 1977, a projected $15 billion surplus on the international services account for the United States (including return on direct investments, transportation, tourism, and insurance) is being relied upon by the U.S. Department of Commerce to bring the total 1977 current deficit into a manageable $10-billion range. In the first quarter of 1977 alone, receipts from private direct investment abroad reached $3.2 billion.

If we are to insure a healthy, international economic system for U.S. business and promote foreign exchange earnings not only from the export of goods but also on the now important service account, including investments, tourism, and transportation, we must maintain the integrity and universality contained in double taxation treaties so as to minimize the possibilities of double taxation or discriminatory and confiscatory taxation on U.S. international business.

The first tax convention for the United States was not finally executed until 1932, becoming effective in 1935. The accomplishments in negotiating treaties since that date have marked an important step forward in regularizing our economic relations with other nations. There is an inevitable clash, of course, between (1) the assertion of unlimited jurisdiction to tax worldwide income based on domicile, citizenship or state of incorporation and (2) the assertion of unlimited territorial jurisdiction based on the claims of the country in which business is conducted. This clash, unless resolved by agreement, can produce crippling and confiscatory double taxation.

A useful philosophical basis for double taxation treaties is given by Professor Dan Troop Smith, the former Deputy to the Secretary of the Treasury for Tax Policy in his 1962 book entitled "Federal Tax Reform." He indicates that through treaties the concept of a permanent establishment has been developed, with provision that each country will tax a foreign company only if it maintains a permanent establishment in the country. Under such treaties, each country usually agrees to allow the income taxes paid in another country as a credit against its own taxes, a right which we give by statute as well. Treaties also contain reciprocal provisions by which the countries concerned agree to waive their rights to tax income which they would otherwise tax under their statutes. The principal effect of such reciprocal provisions is to relieve taxpayers of the annoyance of having to pay taxes in two countries on the same income. Initial transactions and movement of people are encouraged by removing these tax annoyances even though the tax burdens are not reduced.

The establishment of common rules on allocations of income and the concept of permanent establishments along with the reciprocal provisions given in all of our present tax treaties, tends to clarify the basic international principles of taxation, including the concept of primary tax jurisdiction with preemption of conflicting local taxation and the avoidance of double taxation internationally. In the 1970's the international effects of integrating corporate and shareholder taxation as some European countries are now doing, have led to negotiations for modification of certain of our tax treaties, i.e., with the Germans whose own corporate tax integration denies a tax credit on taxes paid on dividends to non-German shareholders. It is important that these conflicts be

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[1] *Taxation and Multinational Firm Behavior: A Critical Survey* by George F. Kopits published in Staff Papers, International Monetary Fund, November 1976, p. 660.

resolved because recent research has shown that while tax differences do not necessarily lure investments from one country to another, there is an "impact of taxes on the flow of direct investment (net capital outflow plus retained subsidiary earnings) and the repatriation of subsidiary earnings in the manufacturing sector." [1] Therefore, with established manufacturing operations, tax differentials do materially affect host and home country returns. Placing U.S. industry in a double tax or unfair situation can affect our expected flow of earnings as a nation.

Several provisions of the U.S.-U.K. tax treaty (specifically Articles 9 and 10) presently before the Committee fit the objectives of tax treaties mentioned above. They will help to maintain and insure the competitiveness of U.S. business on an equal standing with competing foreign enterprises, the substantially equal treatment of U.S. shareholders in the same U.K. corporation, and the nondiscriminatory treatment of U.K. companies here. A provision of the U.S.-Philippines treaty does not.

Foreign policy consideration must take into account the economic relations between the parties. For instance, U.S. direct investment in the United Kingdom at the end of 1975 totaled $14 billion and U.K. direct investment in the United States totaled $7 billion. During the same period U.S. investors received over $1 billion in dividends, interest, branch profits and royalties while U.K. investors were paid in excess of $350 million. Discrimination is now present wth the internal tax changes which have taken place in the United Kingdom, which integrates their tax system. The credit given the U.K. shareholders for the advance corporate tax payments is not extended to foreign shareholders. It is quite likely that this system of integration will continue to spread to more countries on the European continent. Our tax treaties with other countries, such as Germany or France, for instance, will have to be reviewed to alleviate the potential discrimination that exists from their corporate tax integration. The United Kingdom has created a precedent for our negotiations with these and other countries in agreeing (through Article 10) to rebate the tax paid on portfolio investment to U.S. shareholders on a one-for-one basis and to rebate to U.S. corporate shareholders 50 percent of the taxes paid. Without Article 10 the underlying corporate tax rate for a U.S. investment (with respect to distributed profits) will be 52 percent while it is 26 percent for U.K. investors (with allowance for the ACT credit). The incorporation of this article in the U.S.-U.K. tax treaty will mitigate this discrimination caused by the integration in the British tax system, and would seem to further U.S. foreign policy objectives in a nondiscriminatory manner.

Article 9, paragraph 4 of the U.S.-U.K. treaty prohibits any U.S. federal, state, or local government from taxing the business income of any of the related units of a U.K. parent company except income generated by the units located within the United States. This maintains a fundamental approach agreed on by all countries in working out various international tax agreements that a government has authority to tax the income generated and received *within* its jurisdiction.

Your Committee has already heard testimony on the legal rights of the United States to enter into a treaty agreement which affects the individual states. You have also been presented with discussions of the relevant court cases, both on the state and Federal level with regard to the jurisdictions involved and the ability of state governments to tax on the basis of income outside of the state borders. In the only California appellate decision on this issue, for instance, it should be noted that, where foreign operations were involved, the state court placed limitations on the state's ability to tax that income.[2] In cases involving treaties with other countries, state and Federal court decisions have upheld treaty provisions which prohibit or limit a state's ability to tax a portion of home-country earnings.

Several of the states in the United States have complained about the potential revenue loss if they lose their unitary taxing ability on the operations of foreign companies operating within their states. They have indicated that they will lose anywhere from $20 to $50 million. While in a letter to the Chairman of your Committee the Governor of California noted that his state would lose

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[2] *Chase Brass and Copper Corporation* v. *Franchise Tax Board*, 7 Cal. App. 3d. 99, 86 Cal. Rptr 350; 10 Cal. App. 3d, 496, 87 Cal. Rptr 239; 95 Cal. Rptr 805.

over $100 million in tax revenues, the chief counsel of the California Franchise Tax Board has stated in a public meeting that there would be a $15 to $20 million loss in tax revenue if the *foreign operations* of *foreign parents* were not included in the tax base. Oregon believes that $4 to $6 million in revenues will be lost and Alaska believes that $50 million in revenues will be lost.

In assessing the economic advantages and disadvantages here, the total national effect must be viewed as to whether or not there are mutual benefits. Combined, the three states believe that they would lose, at the most, $76 million in revenues if the foreign operations of foreign parents were not included in their tax base. Assistant Secretary of Treasury Laurence Woodworth before your Committee estimated that the retroactive payments alone (by the British Government for taxes already levied) would be approximately $179 million. Futhermore, while there may be some increased Federal taxes paid on the distribution of the $179 million, there would also be additional tax revenues to the states in which the recipient shareholders reside, whether they be individuals or corporations.

In addition to the direct revenue trade-offs, allowance must be made for the foreign investment forestalled and the jobs lost in "unitary tax" states. Testimony before your Committee has shown that corporations such as Sony, Kawasaki, Toshiba, and Pioneer Electronics have either refused to expand operations in "unitary tax" states or have gone elsewhere. In fact, three major U.S. engineering firms have apparently moved operations, with payrolls totaling $100 million, out of California. These moves were precipitated by the refusal of a major foreign-based corporation to conduct business with the engineering firms in California. If the foreign companies mentioned had followed through on their original investment plans, we are convinced that the business activity generated would have more than covered the estimated direct revenue loss claimed as a result of this treaty.

The inclusion of Article 9(4) would also be in line with the recommendations of the Ways and Means Committee of the House of Representatives. Its March 8, 1977 *Recommendations of the Task Force on Foreign Source Income* stated "that the states be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates or corporations doing business within the states until such time as that income is subject to Federal income tax." Favorable action by this Committee on this tax before you will only support this recommendation.

In terms of furthering the U.S. foreign policy objectives, in a nondiscriminatory manner, we are opposed to the elimination of the reciprocal exemption now provided in all U.S. tax treaties for shipping and airline income which is present in Article 9 of the U.S.-Philippines tax treaty. This will enable the Philippines to continue to tax, for example, a share of the gross revenue of U.S.-based airlines serving that country regardless of profitability. It appears that this is an apparent contradiction of the principles of the new U.S.-U.K. tax treaty which retains the traditional reciprocal exemption. We understand that Philippine Airlines, for instance, is exempt from income tax in the Philippines while other international businesses are subject to income tax on their net income only. Article 9(2) of this treaty will permit the continuation of taxation of U.S. international air carriers on the basis of a gross billings concept.

Every treaty since 1940 has contained a reciprocal exemption, thus becoming an unbroken policy of our government for 37 years. Furthermore, the reciprocal exemption was adopted by the OECD in its 1963 model draft double-taxation convention. It should be remembered that airlines and shipping companies, by their very nature, stop at many ports of call, and would potentially be subject to multiple taxation at every point along their routes, with a total tax bill which could, in theory, even exceed total income depending on the various formulas used, and thus be quite literally confiscatory. We also note that the International Air Transportation Fair Competitive Practices Act of 1974 put Congress on record as being against a variety of unfair and discriminatory competitive practices, including discriminatory tax practices against U.S. international air carriers. We would urge that the Congress not break precedent in this area. Service earnings for our balance of payments are now too important to jeopardize, since the government is relying on them to ameliorate a serious payments imbalance.

Finally, I would like to leave with the Committee, for its consideration, one major idea that should be looked at on a long-term basis. There are many issues affecting both developing and industrial countries which are likely to be of heightened importance in the future. They include commodity agreements, special aid facilities, diversification of natural resource development, greater internationalization of petrodollar recycling, and international energy cooperation. In the development area, public sector funds will hardly be sufficient to cover Third World needs so that the private sector in manufacturing, extractive, and service industries must be able to fill the gap where opportunities exist. It is important that we not penalize private transfers of funds, technology, and managerial ability to the less developed countries by actions which we take in the tax area.

Equally, we cannot afford to let such actions jeopardize continuing strength of U.S. business in our best markets in the industrialized countries. In many of them high unemployment levels are also creating pressures toward protectionism, which could easily take the form of adverse tax actions. Therefore, it seems in order for the United States to carefully assess, on a macroeconomic and long-range basis, all projected actions in the tax area, whether by the United States or other governments which will affect the international economic system and U.S. foreign economic relations in particular. Thus, the United States might consider, over and above its work in OECD committees, a series of international taxation and harmonization conferences which would seek to clarify and restate the basic international principles of taxation. In addition to avoiding double taxation, problems with regard to conflicting regulations, such as those governing allocation of expenses, could also be covered along with the international effects of various schemes for integrating corporate and shareholder taxation now being implemented in some European countries.

We see various pressures threatening the system of international tax treaties and understandings, with more and more problems likely to arise in years ahead. Even though harmonization is a long-term and difficult objective, we believe that multilateral review efforts now can help head off erosion in long-accepted principles and should be an important part of our government's overall international economic policy.

THE WHITE HOUSE,
Washington, D.C., August 8, 1977.

Hon. FRANK CHURCH
U.S. Senate, Washington, D.C.

To: Senator Frank Church.

I am writing in response to Senator Javits' request for a statement concerning the absence of a provision with respect to airline taxation in the proposed tax treaty between the United States and the Philippines.

In its negotiations with the Philippines, the Treasury Department tried to obtain provisions to the effect that each country would exempt from tax profits earned by airlines of the other country. By reason of its existing tax agreements, however, the Philippines could not grant an airlines exemption to the United States without at the same time granting it to several other countries. The United States and the Philippines therefore agreed that the treaty would not cover airlines at all, in order to avoid settting a precedent for other tax treaties.

Under the above circumstances, we do not regard the Philippines treaty as a precedent which departs from the principle that airlines should be subject to tax only in their home country; and I assure you that the Treasury Department in subsequent negotiations will insist strenuously on a reciprocal exemption provision.

The treaty would be a substantial benefit to the United States by lowering Philippines taxes on income from the approximately three-fourths of a billion dollars investment which the United States has in that country, and it would improve our ties with this developing and friendly nation.

Sincerely,

JIMMY CARTER.

AIR TRANSPORT ASSOCIATION OF AMERICA,
August 2, 1977.

Hon. JOHN J. SPARKMAN,
Chairman, Committee on Foreign Relations, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

Re Proposed U.S.-Philippine Tax Treaty.

DEAR MR. CHAIRMAN: On July 19, 1977, I presented the views of the airline industry to the Committee in connection with the proposed U.S.-Philippine Tax Treaty. I urged the Committee to withhold ratification of the treaty pending further review and appropriate revision of Article 9(2) by incorporating the standard reciprocal exemption precluding double taxation of U.S. international airlines.

After completing my testimony, and upon the request of your Committee, Dr. Laurence N. Woodworth, Assistant Secretary of the Treasury for Tax Policy, was asked to provide additional testimony on various aspects of the U.S.-Philippine Tax Treaty. In this connection, I would like to provide the Committee with some supplemental information which bears directly on its consideration of the proposed treaty.

I would like to reemphasize that all of the members of the Air Transport Association, which represents virtually all of the scheduled airlines of the United States, are unanimous in their view that Article 9(2) should incorporate the standard reciprocal exemption for international airline operations. Pan American is not the only airline affected by a Philippine tax on gross Philippine billings. Flying Tiger and Northwest Airlines also are affected. And while TWA does not operate to the Philippines, ticket sales at TWA's Philippine office arguably would not be exempt from taxation under a revised aviation provision similar to the shipping provision contained in the proposed treaty, as has been suggested. It is true that, if the treaty included a 1½ percent tax on gross Philippine billings, Pan American, TWA, Flying Tiger, and Northwest Airlines would be benefited. However, the precedential effect of such a provision would be to expose these and other U.S. international airlines to local taxation in other developing and developed countries. Senator Church recognized this problem during Dr. Woodworth's testimony by noting the concern about the consequences of this precedent. The enclosed telegrams from TWA and Flying Tiger emphasize the importance with which they view the retention of the reciprocal exemption and their support of the industry position.

We are also deeply concerned because the proposed treaty permits highly discriminatory Philippine taxation of U.S. international airlines. Mr. Paul Oosterhuis, Legislation Counsel for the Joint Committee on Taxation, recognized in his testimony before the Committee that there is at least some discrimination which would be permitted to continue under the treaty. We believe that it is a much more serious problem. Philippine Airlines (PAL) is only subject to a 2 percent franchise tax in the Philippines on its receipts, while other international airlines are not only subject to a 2 percent franchise-type tax, but are also subject to a 2½ percent gross billings tax on all of their receipts attributable to the Philippines, and a 20 percent profits remittance tax. We view this difference as effectively discriminating against international carriers in favor of PAL. We have enclosed a brief Summary Memorandum which further explains this discrimination.

We find it difficult to understand how the omission of the reciprocal exemption can do other than serve as a clear precedent in future treaty deliberations. Indeed, notwithstanding statements to the contrary, we are certain that the omission of the reciprocal exemption will be treated as a precedent in future treaty negotiations. The reciprocal exemption of airline profits is a standard provision found in all twenty-five tax conventions currently in force, the model Treasury Department treaty, the O.E.C.D. Draft Convention, as well as in the other treaties pending before this Committee for ratification. Moreover, the Internal Revenue Code in Sections 872(b)(2) and 883(a)(2) exempts earnings of foreign airlines in the U.S. if an equivalent exemption is granted to U.S. airlines by the foreign country.

The standard reciprocal exemption provides the airline industry with the basic protection from double taxation. Precluding double taxation is the fundamental purpose of all tax conventions. Denying this basic protection to the airline industry for the first time in the history of treaty negotiations is an

extraordinary departure from established U.S. policy, an undeniable new precedent, and an action which will provoke demands for similar favorable treatment from other countries. It will serve as an example to authorize or justify the omission of the reciprocal exemption from future treaties. Indeed, it may act as a model for future negotiations in treaties with other developing nations. Moreover, on a very practical level, it places U.S. negotiators in a very untenable position. In future negotiations, other nations can point to Article 9(2) as a precedent accepted by the Treasury and State Departments, the Senate, and the President.

In any event, contrary to statements made on July 20, the proposed Philippine treaty does not "omit" all references to the taxation of international airlines. Article 9(2) of the treaty specifically provides that the Philippines may tax international airlines in accordance with its domestic laws, and for this reason must be viewed as a dangerous precedent. Such a provision, which flies in the face of every other U.S. treaty currently in force, will serve as a stepping stone in future negotiations with developing and developed nations.

We hope that your Committee will share our concern on this very important question and withhold ratification of the treaty pending further review and appropriate revision of Article 9(2) by incorporating the standard reciprocal exemption precluding double taxation of international airlines.

Sincerely,

NORMAN J. PHILION.

Enclosures.

Text of telegrams submitted to Laurence N. Woodworth, Assistant Secretary for Tax Policy, Department of the Treasury on July 19 and July 20, 1977, respectively

"This is to confirm Flying Tiger's endorsement of testimony presented today to the Senate Foreign Relations Committee concerning the proposed U.S.-Philippine Tax Treaty. We agree that proposed Treaty should not be ratified pending further review of Article 9(2) and appropriate revision incorporating standard reciprocal exemption to preclude double taxation of international airlines."

JOSEPH J. HEALY,
Executive Vice President
and Chief Operating Officer,
The Flying Tiger Line.

"Re Philippine Tax Treaty. TWA supports the concept of reciprocal tax exemption in all treaties which are negotiated with foreign states including the treaty negotiated with the Philippines. The Philippines treaty is particularly onerous in that it makes no provision for special tax treatment of airlines whether or not they serve the Philippines. Currently the Philippines is attempting to extend its taxing jurisdiction to include airlines such as TWA which do not serve the Philippines. We believe this to be an unconscionable and improper exercise of its dominion over airlines which do not serve the Philippines.

"The Philippines Treaty in its present form is unacceptable and should not be ratified. Major modifications are required therefore the Treasury Dept. should renegotiate to include reciprocal exemption."

C. E. MEYER, JR.,
President and Chief Airline Executive,
Trans World Airlines, Inc.

Summary Memorandum

COMPARISON OF TAXES APPLICABLE TO PHILIPPINE AIRLINES AND INTERNATIONAL AIR CARRIERS

Philippine Airlines (PAL) is only subject to a 2 percent franchise tax in the Philippines on its total gross receipts, but all foreign international carriers are subject to a 2 percent franchise-type tax on total gross receipts attributable to Philippine sources, a tax of 2½ percent on gross Philippine billings, and a 20 percent profits remission tax on profits remitted abroad by a branch office

to its home office.[1] It is true that the Government of the Philippines, under general jurisdictional nexus rules for taxing income, may only tax income attributable to the Philippines. However, this is the limit of its jurisdictional ability to tax income of a foreign corporation. Consequently, while PAL is subject to a 2 percent franchise tax on all of its receipts, international carriers are not only subject to a 2 percent franchise-type tax on all of their receipts attributable to the Philippines, but are also subject to a 2½ percent gross billings tax on all of their receipts attributable to the Philippines, and a 20 percent profits remittance tax. We view this difference as effectively discriminating against international carriers in favor of PAL.

In addition, in the United States, PAL is subject to a tax limited to a formula based upon net income attributable to sources within the United States. The United States international carriers are subject to tax on total worldwide income.

In the United States, the rate of tax imposed upon domestic corporations is identical to the rate of tax imposed on PAL. Consequently, if we look at the entire picture, we find that the imposition of tax by the United States on PAL, as compared to the imposition of tax by the Philippines upon foreign international carriers, is discriminatory.

U.S.A. BRANCH,
INTERNATIONAL FISCAL ASSOCIATION, INC.,
New York, N.Y., July 28, 1977.

Hon. JOHN SPARKMAN,
Chairman, Senate Foreign Relations Committee, Dirksen Senate Office Building, Washington, D.C.

Attention: Miss Connie Carmichael.

DEAR SENATOR SPARKMAN: On behalf of the USA Branch, International Fiscal Association, I am pleased to submit our statement in connection with your current consideration of the U.S. tax treaties with Korea, Philippines and United Kingdom. We trust it will assist your Committee in its deliberations.

Yours very truly,

RICHARD M. HAMMER,
President.

Enclosure.

STATEMENT OF RICHARD M. HAMMER, PRESIDENT, USA BRANCH INTERNATIONAL FISCAL ASSOCIATION

We deeply regret the inability of the Committee's staff to schedule an appearance for us at the July 19-20 hearings dealing with the ratification of five treaties, inasmuch as our organization is so uniquely equipped to provide meaningful input in the tax treaty area.

THE ORGANIZATION AND ITS BACKGROUND

(*1*) *General*

The International Fiscal Association (IFA) is a worldwide organization whose members include governmental officials, lawyers, accountants, economists, corporate executives and members of the academic community who have a continuing interest and professional involvement in international tax problems and their relationship to international trade and investment.

The Association was established under the law of the Netherlands in 1938, and its headquarters remain to this day in Rotterdam. Today there are branches of IFA in 25 or more countries throughout the world. Worldwide membership now exceeds 6,000 persons, of which approximately 600 are in the USA Branch.

(*2*) *Objective*

The aim of the Association is to study and discuss the fiscal and economic effects of continually evolving international tax legislation and *treaties* on

[1] It should be noted that the 2 percent franchise-type tax on foreign international carriers is contained in Title V, §192 of the Philippine National Internal Revenue Code and, therefore, is not creditable under the proposed United States-Philippine Treaty.

world trade and investment. Consideration is given to reconciling the competing necessities of raising revenue and promoting foreign commerce and investment within the framework of the variable tax and fiscal systems of the nations of the world. The best understanding of international tax problems, particularly treaty matters, can be obtained by an exchange of views of persons throughout the world who deal with these problems on a day-to-day basis. This objective is met by an Annual Congress and the preparation, discussion and dissemination of in-depth studies called "Cahiers" (booklets) on particulars of the countries involved. Tax treaty matters have often been the subject of these Congresses and Cahiers.

For example, the following subjects have ben dealt with in recent (including the forthcoming 1977) Congresses and in the related Cahiers:

1977—Determination of the taxable profits of corporations. Inflation and taxation.

1976—Tax incentives as an instrument for achievement of governmental goals. The definition of capital gains.

1975—Tax treatment of importation and exportation of technology—know-how, patents and other intangibles and technical assistance. Allocation of expenses in international arm's length transactions of related companies.

1974—Tax consequences of domestic and foreign interests establishing corporations as vehicles for joint ventures. Tax problems resulting from the temporary activity abroad of employees of enterprises with international operations.

1973—The taxation of enterprises with permanent establishments abroad Partnerships and joint enterprises in international tax law.

Obviously, treaty considerations are an integral part, to a greater or lesser degree, of these subjects and are thoroughly explored and discussed in the written material and the oral discussions.

(3) *Local activities*

Branches of the IFA have been organized in over 25 countries. These national branches attempt to provide the members with the latest views of noted authorities on topics which are of current interest in the international tax field.

The USA Branch has a number of Regional Committees, viz., New York City, Mid-Atlantic, Washington, Southeast, Southwest, Midwest and Western Regional Committees. These Regional Committees conduct educational seminars, luncheon meetings and other programs throughout the year. Treaties have played a prominent part in the educational programs of the USA Branch.

THE ROLE OF TAX TREATIES IN INTERNATIONAL COMMERCE

The continued growth of international investment and trade, coupled with the increasing complexity of the revenue laws of the nations of the world, have made tax treaties of greater importance today then ever in the past. Moreover, their importance to international commerce will continue to accelerate in the years ahead. Despite the unilateral measures taken by many of the developed nations to avoid double taxation, the tax burdens on the international operations of multinational enterprises (in the absence of tax treaties) would still be higher than their domestic burdens so as to reduce, in some cases substantially, the return on foreign investment. Thus one of the primary purposes of treaties is to reduce, if possible eliminate, the incidence of international double taxation.

Although the U.S. Internal Revenue Code unilaterally grants relief from double taxation through its foreign tax credit mechanism, the foreign tax credit limitation (Section 904) will only provide relief to the extent of the U.S. tax attributable to foreign source income. Accordingly, to the extent that foreign withholding taxes, in conjunction with the underlying corporate income taxes of a dividend paying overseas affiliate which are creditable under the U.S. deemed paid credit rules (Section 902), increase the foreign burden above the U.S. rate, the yield to the U.S. investor is reduced by comparison with domestic investment. Furthermore, the imposition of withholding taxes discourages distributions to U.S. shareholders. The U.S. treaty network is intended to reduce such withholding taxes, ideally to a level which may permit the U.S. taxpayer a full offset for the creditable taxes. With the ever increasing

rates of corporate taxation abroad and the new IRS regulations on allocation and apportionment of deductions to foreign source income (Reg. Sec. 1.861-8), treaties are becoming more significant to U.S. business operating internationally to reduce the degree of double taxation. The same considerations are important to taxpayers domiciled in the nations which are our treaty partners in connection with their foreign investment, both in the U.S. and third countries.

But treaties are not merely of benefit to taxpayers. Another, equally important, purpose of tax treaties is to assist tax administrations in preventing tax evasion. Thus, when two nations enter into a tax treaty, they agree to cooperate with and assist each other, primarily through the exchange of information and, in some instances, through the actual collection of taxes on behalf of each other.

From the point of view of both the world business community and the various national fiscal administrations, bilateral tax treaties are universally accepted as being in the best interest of promoting international trade and investment. For example, the Fiscal Committee of the Organization of Economic Cooperation and Development, an intergovernmental body representing 24 nations, in 1963 issued a draft model tax convention, which it has from time to time revised and updated (the last such revision having been issued in 1974), for the purpose of assisting its members in entering into tax treaties with each other and with nonmember states. Moreover, for several years, a group of tax experts, sponsored by the Economic and Social Council of the United Nations, has been meeting to prepare a model convention for use in treaty negotiations between developed and developing nations, with a view toward recognizing the special fiscal problems of the developing nations. The U.S. Treasury itself has issued model income tax and estate tax conventions on which its negotiations are based.

TREATY MECHANICS

Under our federal system, the executive branch has the responsibility for initiating, negotiating and concluding bilateral treaties with the governments of other countries. Normally, this is the province of the Department of State, although in the tax treaty area theDepartment of Treasury has been delegated the role of negotiator because of the technical nature of these agreements. Once a treaty has been signed, it must be submitted to the Senate for "advice and consent" as to its ratification by the President. Once ratified, a tax treaty governs the transactions covered and its provisions override the Internal Revenue Code (Section 894).

(1) Public comment

Unlike the normal legislative process, the treaty negotiating process provides no opportunity for the interested members of the public to be informed about and to comment on a particular treaty until it has been signed and submitted to the Senate. In fact, up to that point, the negotiations are conducted in secrecy. The first formal call for public comment occurs at public hearings conducted by the Senate Committee on Foreign Relations for the purpose of ascertaining whether or not the Committee should recommend to the Senate that it provide its advice and consent. At this point, it is often too late for interested parties to make constructive suggestions, and the hearings usually provide a forum for endorsement of the treaty in *toto* by those in favor of the treaty or for objection to the entire treaty or particular provisions by others. If the hearings produce substantial and numerous objections, the result may be further delay in the Committee review, a Committee recommendation that the Senate's advice and consent be withheld, or that the Senate reserve with respect to specific provisions and consent to the balance of the treaty, which may require renegotiation of the treaty.

We believe that this is a cumbersome and inefficient manner in which to conclude tax treaties. It deprives the negotiators of the benefit of timely comment by those in the business, professional and academic communities who are closely involved with international tax problems. We strongly urge that consideration be given to developing procedures in the tax treaty process to allow for greater public comment from the early stages of negotiation through the signing of the treaty. The Committee on Tax Treaties of the U.S. Branch

of the IFA is presently developing recommendations for opening the treaty process to earlier public input, including the possibility of the Treasury Department publicly identifying significant issues on the agenda in bilateral negotiations.

We appreciate the need for the government negotiators to maintain control over the negotiations and for a degree of confidentiality in the conduct of intergovernmental negotiations. At the same time we also see the desirability of reducing the necessity for amendment and renegotiation of signed treaties and for providing maximum access to information for the conduct of negotiations.

We note that the Treasury Department has taken an important step in making publicly available the model treaty from which it negotiates and we are hopeful that the Treasury Department will publish a United States commentary to that model for guidance as to United States treaty objectives and as an aid to interpretation.

(2) Time frame

An additional consideration in the tax treaty procedure is the frequent long delays between the signing of a treaty and its ratification. If possible, we would urge that the Senate Committee on Foreign Relations attempt to expedite its consideration of treaties following their execution. For example, the five treaties originally scheduled for consideration by the Committee at these hearings and the dates on which they were executed are as follows:

Egypt [1]—October 20, 1975; Israel [1]—November 20, 1975; Korea—June 4, 1976; Philippines—November 24, 1976; and United Kingdom—December 31, 1975.

The most significant of the above treaties from the point of view of magnitude of investment flows, the treaty with the United Kingdom, was executed over a year and a half ago. The other treaties, significant in that they represent treaties with developing nations (of which the U.S. has very few presently in force), range from 21 months to 7 months. The essential point is that such delays cause difficulties for U.S. investors in planning and structuring near-term future overseas investments in the particular country or countries because of the vacuum created by a pending treaty vis-a-vis no treaty (Egypt, Israel, Korea, Philippines) or an older treaty (U.K.). Similar uncertainties arise for individuals who are relying on tax treaties.

Of particular relevance, we might point out an accounting (financial statement) problem created by the long pendency of the U.K. treaty. Article 10(2)(a)(i) grants a refund of a portion (one-half) of the U.K. Advanced Corporation Tax (ACT) levied on a U.K. corporation incident to its paying a dividend to a U.S. direct investor (i.e., the U.S. corporate owner of at least 10 percent of the voting stock of the U.K. dividend paying subsidiary). This refund feature is retroactive to dividends paid by a U.K. company after April 6, 1975. Accordingly, at December 31, 1975 and again at December 31, 1976, the question arose as to whether or not it would be appropriate to give recognition to the effect of the potential ACT refund in the reported consolidated financial statements of U.S. corporations having received dividends from their U.K. affiliates after April 6, 1975. The effect would be twofold, increasing reported income and assets. Many corporations and their auditors were faced with the decision of whether or not to recognize this benefit, in view of the lack of certainty that the treaty would be ratified. After facing this problem at year-end 1975, the issue was still undecided at year-end 1976, a factor solely due to the failure to expedite the ratification process.

TREATY REVIEW

Since the community of nations began the negotiation of treaties in the 1930's, national tax laws have become infinitely more complex and tax authorities have become increasingly sophisiticated both in policy and enforcement. Thus treaties have evolved from very simplistic arrangements to the highly sophisticated intergovernmental contracts that they represent today.

Modern treaties are generally constructed as a total package resulting from the give and take of negotiations by representatives of the fiscal administrations of two countries attempting to find the proper balance among capital

[1] Withdrawn at last minute due to technical problems.

flows, inter-country trade, and revenue losses. The principal effort involves the meshing of often different and sometimes conflicting substantive tax rules. The negotiation process pits, in essence, two parties at adverse interest, so that the resulting treaty treads the fine line of compromise between these adverse interests. Accordingly, a reservation by the Senate on one particular provision may well destroy this balance and result in a signed treaty being rejected by the treaty partner. We urge that the Senate in considering negotiated tax conventions enter reservations only for the most compelling reasons and only when there is a conviction that the provision of a treaty was clearly erroneous.

TREATY CONTENT

It is not within the intended scope of this testimony to discuss specific provisions which should be encompassed in a tax treaty to which the United States is a signatory. I would like to mention, however, the significance of two provisions of the pending treaty with the United Kingdom. Under that treaty, the United Kingdom has agreed to extend the United Kingdom system of integration of corporate and shareholder taxes to United States investors, 100 percent to United States portfolio investors and, of particular importance, 50 percent to United States direct investors. This is the first time that a treaty partner has offered to United States direct investors some portion of the integration credit that is allowed to their residents. France previously extended its *avoir fiscal* integration credit solely to U.S. portfolio shareholders (individuals and corporations owning less than 10 percent of a French company's voting shares) through a protocol (signed October 12, 1970) to the existing treaty between France and the U.S. (signed July 28, 1967). It is believed by the U.S. Treasury Department treaty negotiators that the U.K. treaty, which mitigates, as to U.S. investors, the discrimination against foreign investors inherent in an integration/credit system will establish the pattern for current negotiations with important treaty partners, including Canada, France and Germany.

A second development in the U.K. treaty is the requirement that at both the federal and state levels the income of related corporations in the two countries be determined by an arm's length standard, thus precluding the application of unitary tax rules applied by some states to foreign corporations controlled by U.K. residents if such corporations are not engaged in business in the U.S. This restriction on state taxation of international investment must be weighed by the Committee in the traditional exercise of the treaty power in balancing the need for national rules in international relations with the interest of individual states. The arm's length standard provided in the treaty was recognized at the 1975 Congress of the International Fiscal Association as the accepted international practice and is the rule adopted in the model income tax treaty of the OECD, which applies at both national and local levels, and in the commentaries of the U.N. ad hoc experts on tax treaties with developing countries.

STATEMENT BY EMERGENCY COMMITTEE FOR AMERICAN TRADE

NOTES ON THE U.S.-U.K. TAX TREATY

The U.S.-U.K. treaty, which recently was approved by the British Parliament, is before the Senate for ratification It updates and adds new provisions to the existing 1945 treaty.

The two key provisions are Articles 9(4) and 10. Article 9(4) restricts the ability of states under a unitary system to tax the non-U.S. income of British-owned companies, including their subsidiaries in the U.S. Article 10 provides for a refund of a portion of the U.K. corporate tax to U.S. shareholders of British companies. The two articles appear to be closely related. U.S. disapproval of 9(4) would most likely lead the British to reconsider their earlier ratification of Article 10, and perhaps of the whole treaty.

ARTICLE 9(4)

The unitary system of taxation is used primarily by California, Oregon and Alaska. A few other states apparently use some of the system's concepts but on an irregular basis. The system differs from that used by most states in

that it sweeps foreign source income into the state's tax base, and does so regardless of whether such income bears any relation to business conducted within the state. Federal and international practice require such a relationship.

California, Oregon and Alaska strongly oppose Article 9(4), and have urged the Senate not to ratify it. They have been joined in opposition by ya group of about 20 other states of the Multistate Tax Commission. These states—primarily Western—are considering the unitary system and, together with those using the system, do not want the Federal Government interfering in the manner in which they tax or propose to tax overseas income. They view the issue, therefore, as one of Federal interference in states' rights—in this instance the right to tax overseas income in a manner of their choosing.

Closely related to the states' rights issue is the question of whether the Federal interference should be via the treaty route—Article 9(4)—or the regular legislative route. Congressman Al Ullman has asked the Senate to reserve on the article since it involves a tax matter that the Ways and Means Committee intends to take up in connection with general tax reform. Senator Frank Church, who chaired the July 19-20 hearings, seems to agree with Mr. Ullman.

The two major issues concerning ratification of Article 9(4), therefore, are that of states' rights and that of legislative procedure.

On states' rights, all seem to agree that the Federal Constitution provides for Federal primacy in disputes such as that involved in Article 9(4). There are judicial precedents and tax and other treaty precedents that limit taxing powers of the states when international considerations are involved.

The real issue, therefore, appears to be that of procedure, i.e., whether state taxation of foreign source income should be limited by Federal legislation or by a bilateral tax treaty, such as that between the U.S. and the U.K.

There are meritorious arguments on both sides of the issue. Arguing for the legislative route is its allowance for a more thorough congressional consideration of the issues involved than does the ratification route, which limits consideration to the Senate alone. Furthermore, the Senate examination is in a foreign relations context and not in a tax context. The House Ways and Means Committee, through its recent Task Force on Foreign Source Income, already has studied and made recommendations concerning the unitary system and its relation to the Federal system of taxing foreign income. (The recommendation is that the states not go beyond the Federal system, which accords with the principle involved in Article 9(4).) Another argument in favor of legislation is that the U.S.-U.K. treaty would limit state taxation of foreign source income only in regard to British companies, leaving all other companies subject to such taxation.

These are persuasive arguments. Equally persuasive are the arguments for Senate ratification of Article 9(4). The treaty is a perfectly proper exercise of the treaty authority of the Federal Constitution, and its provisions accord with precedent and international practice. Ratification of treaties is constitutionally limited to the Senate. Tax treaties fundamentally affect foreign relations—as does the U.S.-U.K. treaty—and they are essential to promoting the international commerce and investment of the United States. In so doing, they sometimes in the national interest override the narrower interests of states. The issue of state taxation involved in Article 9(4) was raised by the U.K. in the course of negotiations as an important bilateral problem and impediment to U.S.-U.K. commerce. Its inclusion in the treaty is, therefore, appropriate and even essential. Without its inclusion, the treaty would have been quite different. If the article is not ratified, there could be no treaty at all since the British have indicated the probability that they would withdraw their ratification and start renegotiations on a new and different tax treaty.

ARTICLE 10

Should Article 9(4) not be ratified, the consequences would be most harmful. Article 10 would most likely be lost. It provides for a substantial refund of the British advance corporate tax to U.S. parents of U.K. subsidiaries, which could have the effect of reducing the U.K. tax from 52% to 42%, thereby putting U.S. investors in the same position as British investors. There would thus be a flow of many millions of dollars—perhaps as high as hundreds of millions of dollars—into the U.S. economy. The Federal Treasury would benefit

since the U.S. parent would pay Federal income tax on the difference between the 42% U.K. rate and the 48% U.S. rate.

The British are the first country to negotiate such a tax benefit for U.S. shareholders. The refunds presently provided British shareholders—and prospectively U.S. shareholders if the tax treaty is ratified—flow from the British integration of their income tax in order to avoid double taxation of corporate dividends. The British government now refunds to *British* shareholders of British corporations the corporate tax paid on the income distributed to the shareholders. Article 10 would extend this to U.S. parents of British companies.

As a matter of fact, no country utilizing a similar system of income tax integration extends the benefits of such integration to U.S. parent corporations. France, West Germany and Canada have such systems. This places U.S. subsidiaries in a disadvantageous position vis-a-vis their competitors in these countries. U.S. negotiators are seeking from them the same provision as is in Article 10 of the U.K. treaty, which makes even more pivotal the ratification of the U.S.-U.K. treaty. With it as a precedent, the chances for success in other tax treaty negotiations would be considerably enhanced and another impediment to international economic cooperation removed.

CONCLUSIONS

Relating Article 9(4) to Article 10 and other valuable provisions in the treaty, the questions of ratification and procedure become critical. If, for example, Article 9(4) were not approved, the likelihood is that Article 10 and its direct benefits would be lost. Moreover, were the limits on the unitary tax in Article 9(4) to be legislated rather than accomplished through the treaty, there would be no apparent reason for the British to extend to U.S. shareholders the tax refunds provided in Article 10 since they would receive the benefit of 9(4) without the need for payment.

This argues persuasively for Senate approval now of Article 9(4). Its ratification, however, need not be inconsistent with subsequent legislation. Since only British-owned companies would be exempted from the objectionable foreign income provisions of the unitary tax system, it could be expected that others would seek the same treatment either through the courts or through the state and Federal administrations or legislatures. The preferable course would appear to be for the states to make the adjustments but, failing that, a Federal statute might be in order.

Although negotiated by the Ford Administration, the U.S.-U.K. tax treaty is strongly supported by the Carter Administration. Its ratification by the Senate will provide meaningful benefits to both countries and will in no way foreclose future consideration of the foreign income provisions of the unitary system by the Congress.

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC. ON RATIFICATION OF THE CONVENTION BETWEEN THE UNITED STATES AND THE UNITED KINGDOM FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL GAINS

The National Foreign Trade Council, Inc., which was founded in 1914 and whose membership comprises a broad cross-section of U.S. companies engaged in all aspects of international trade and investment, including trade with and investment in the United Kingdom, supports ratification of the Convention Between the United States and the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, as signed on December 31, 1975 and as amended in April 1976, together with the First Protocol signed by both governments in August 1976 and the Second Protocol which was proposed in February 1977.

The underlying basis for strongly urging that this Convention, as amended and supplemented, be ratified by the Senate is twofold. One is the importance of the Convention as it relates to the coordination between a classical system of taxation, such as the one employed by the U.S., and an imputation system of taxation, such as the one employed by the United Kingdom. The second is the provision of the Convention that relates to the matter of the taxation of multinational enterprises by political subdivisions of the U.S. and U.K.

The proposed Convention between the U.S. and the U.K. contains a provision, in Article 10 thereof, which permits a partial refund of the U.K. advance

corporation tax (ACT) paid with respect to distributions to U.S. corporate shareholders. Under Article 10, the amount of the refund paid by the U.K. Government is equivalent to one-half of the ACT minus a five percent withholding tax. We feel that this provision represents an important step in minimizing potential discriminatory tax treatment of U.S. investors abroad. Generally, the effect of this provision is to reduce the U.K. tax burden on fully distributed earnings to approximately 42%, at which point there will be additional U.S. tax due of approximately 6% on those earnings when they are received by the shareholder; the U.S. shareholder would thus net approximately 52% of the distributed earnings.

If the refund provision is not available, the U.K. tax burden on fully distributed earnings would be 52% and there would be no residual U.S. tax due on the distribution. The U.S. shareholder would therefore net only 48%. Accordingly, the absence of any refund provision would result in less tax revenue for the U.S. Treasury and generally a higher total tax burden for the U.S. investor.

Moreover, we believe that this refund provision will prove extremely valuable in connection with negotiating income tax conventions with other countries which employ an imputation system of taxation or variations thereof. We understand negotiations have been instituted with West Germany in view of their new imputation system, which became effective January 1, 1977; we have also been informed that negotiations are under way with other countries, such as Canada and France, which involve similar considerations for non-resident U.S. shareholders. It is clearly in the interest of the United States to encourage foreign tax authorities not to discriminate against U.S. investors and, as indicated, we believe that the proposed Convention is an important step in that direction.

With respect to the matter of the taxation of multinational enterprises by individual states of the United States, the Convention, as amended, seems to us to strike a fair and reasonable balance between the various competing considerations which are involved. As originally proposed, Article 9(4) of the Convention could have been interpreted to preclude the states from including U.S.-controlled foreign corporations doing business in the United Kingdom within worldwide apportionment formulas employed by these states. As it was amended in April 1976, the Convention now clearly provides in Article 9(4) that the states will not be precluded from including U.S.-controlled foreign corporations within the tax base from which the state tax is calculated. However, the states will not be able to include a portion of the income of a U.K. parent or its related foreign corporation within that tax base unless such corporations are actually engaged in business in the U.S. Since the Federal Government essentially limits its taxation of foreign corporations to their income derived within the U.S., we do not believe it unreasonable for the U.K. to request a provision in the treaty prohibiting the states from including in the tax base of U.K. corporations doing business in a state an amount greater than that includable by the Federal Government. We, therefore, support proposed Article 9 as an appropriate provision applicable to U.K. corporations doing business in the U.S.

In summary, we urge ratification of the proposed treaty in its present form as an equitable solution to problems arising from the different tax structures of the U.S. and U.K. and, very importantly, such ratification will provide a precedent for treaties with other countries.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., July 14, 1977.

Hon. JOHN SPARKMAN,
Chairman, Committee on Foreign Relations, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR SPARKMAN:

POSSIBLE RATIFICATION OF THE REVISED UNITED STATES-UNITED KINGDOM INCOME TAX TREATY

The Machinery and Allied Products Institute is pleased to have this opportunity to submit its views to the Senate Foreign Relations Committee regard-

ing possible ratification of the revised United States (U.S.)-United Kingdom (U.K.) Income Tax Treaty. In that connection, we request that this statement be made a part of the public record being compiled now by the Committee on this subject.

We should note at the outset that the efforts of our federal government to secure tax harmonization with other countries are of direct or indirect consequence to all U.S. citizens. The treaty negotiating program of the U.S. Department of the Treasury is especially significant as it relates to the major trading partners of this country. All residents of Contracting States stand to benefit from the mutual understandings and concessions which reduce or eliminate tax barriers to international trade. Also, we all generally benefit to the extent that the taxing practices of Contracting States are made more uniform and predictable and Competent Authority procedures are provided for the expeditious resolution of disputes.

As to our particular concern with the revised U.S.-U.K. income tax treaty, most of MAPI's member companies are U.S.-based corporations which have permanent establishments—usually wholly owned subsidiaries—in the United Kingdom. Also, in some few instances, the Institute's member companies are U.S. subsidiaries of U.K.-based corporations. In either case, these organizations have substantial investments in both countries, and extensive trade activity from and between them. A revised U.S.-U.K. income tax treaty is highly important to these companies because of tax law changes which have occurred in the Contracting States in recent years and are not reflected in the 1945 Convention, as amended.

To state our position in brief, we urge the Senate Foreign Relations Committee to recommend that the full Senate give its advice and consent to ratification of the revised U.S.-U.K. income tax treaty *without reservation*. We understand that the treaty—as initiated at the ambassadorial level on December 31, 1975, amended by Notes exchanged on April 13, 1976, and supplemented by several Protocols since then—has already been approved by the U.K. House of Commons. If the Committee and the full Senate will act accordingly, the Compact will then be ratified and become effective with important precedent-setting concessions to residents of both Contracting States.

Further in that regard, the most significant single feature of the revised U.S.-U.K. Income Tax Treaty is Article 10 on "Dividends." This Article provides a mechanism by which the U.S. shareholders of a U.K. corporation will receive certain shareholder tax credits which have heretofore not been granted to U.S. residents. This is an equitable adjustment to put U.S. shareholders of U.K. companies more nearly on a par with U.K. shareholders of such companies under the U.K. system of integrated taxation for corporations and shareholders introduced in 1973. Further, Article 10 will encourage the payment of dividends from U.K. corporations to their U.S. shareholders, thereby benefiting the U.S. balance of payments and U.S. revenues. Also, this Article will set an important precedent for the renegotiation of income tax treaties with other countries which have—or will eventually have—integrated tax systems that do not fully recognize U.S. investors.

As nearly as we can discern, the only objections being raised about this treaty are those of some state government officials on the U.S. side. These few state government representatives frown on Article 9(4) dealing with "Associated Enterprises" because it limits their assertion of jurisdiction pursuant to the "unitary" concept whereby the states in question include in the tax base of a local company the income of certain of its foreign affiliates (as more fully discussed later in this letter). It should be noted that this approach to income taxation now followed by several state governments contravenes the basic principle of taxing jurisdiction in existing U.S. income tax treaties. As another indication of the impropriety of the practice circumscribed by Article 9(4), the Task Force on Foreign Source Income of the House Committee on Ways and Means recommended in its report of March 8, 1977 that the states be precluded from taxing income on the basis which is prohibited by the revised treaty.

It is MAPI's understanding that the U.K. treaty negotiators consider Article 9(4) to be an important concession to their interests. Also, it is regarded as a *quid pro quo* for their allowance of shareholder tax credits for U.S. resident recipients of dividends from U.K. companies. Therefore, if the parochial in-

terests of a few state governments were to result in the taking of a reservation by the United States with respect to Article 9(4), it would appear that the very significant Article 10 benefits would be sacrificed in exchange. We concur in these aspects of the revised treaty, as negotiated and already approved by the U.K. House of Commons, and urge that the Committee recommend approval and ratification on that basis.

We should add that our position in favor of the revised U.S.-U.K. treaty, as negotiated, and more particularly with respect to Articles 10 and 9(4) accords with the views of the Treasury Department in this matter, as set forth in the February 15, 1977 letter of Secretary Blumenthal to Mr. Martin Huff of the California Franchise Tax Board, transcribed copy attached. We understand that Assistant Secretary for Tax Policy Woodworth will reaffirm the position set forth in Secretary Blumenthal's February 15 letter and otherwise testify in favor of the revised treaty at the public hearings to be held next week.

Our more detailed comments are set forth below following a background note.

BACKGROUND

The U.S. Treasury Department announced in November 1975 that delegations from the United States and the United Kingdom had reached agreement on a new income tax treaty which was intended to replace the 1945 convention then —and still—in effect.[1] Subsequently, in January 1976, Treasury reported that the revised treaty had been signed on December 31, 1975 by both governments, and would be sent to the U.S. Senate for its advice and consent to ratification and to the U.K. House of Commons for approval.[2] The document was amended by Notes exchanged by the two governments on April 13, 1976; was presented by the Ford Administration to the Senate for consideration on June 24, 1976; was supplemented by a first Protocol signed August 26, 1976 and a second Protocol concluded in the spring of 1977; and is now before the Senate Foreign Relations Committee for review.

Advance Corporation Tax

The revised treaty reflects various changes that have evolved in the Model Convention prepared by the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development. However, the more important reasons for treaty revision were the U.K. tax law changes enacted in 1973.

In particular, the United Kingdom introduced in 1973 a system of integrated corporate and shareholder taxation. Under this system, an "Advance Corporation Tax" (ACT) is paid at the corporate level on a distribution of dividends by the corporation. The ACT serves both as an advance payment of a portion of the corporate income tax and as a payment by an individual U.K. resident shareholder in satisfaction of his personal tax liabilities on the dividend. More specifically, the ACT is creditable against the corporate tax liability of the paying corporation; is treated as income of the U.K. shareholder; and entitles the shareholder to a refundable tax credit against his personal tax liability.

In accordance with the 1973 U.K. tax law, the refundable tax credit for the ACT was made available to U.K. shareholders of U.K. corporations, but not to foreign shareholders of those companies. Hence, it has been necessary to revise the U.S.-U.K. income tax treaty to prevent or lessen discrimination against U.S. investors in U.K. corporations. In brief, Article 10 of the revised treaty provides that the United Kingdom will grant a tax credit in the form of a payment to U.S. shareholders of U.K. corporations with respect to the ACT collected in the United Kingdom.

ACT credits for U.S. shareholders.—To describe Article 10 in more detail, if the U.S. shareholder is a corporation which controls 10 percent or more of the voting stock of a U.K. corporation, the ACT payment will equal one-half of the credit which would be payable to an individual U.K. resident, less 5 percent of the aggregate amount of the dividend and the payment. For U.S. tax purposes, the amount of this payment will be considered a dividend by the paying corporation and the 5 percent withheld will be considered a tax on the shareholder receiving the dividend. The unrefunded portion of the ACT paid in respect of the dividend will be regarded as a tax on the distributing corporation.

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[1] See Treasury New Release WS-454 of November 4, 1975.
[2] Treasury News Release WS-562 of January 6, 1976.

In the case of other U.S. shareholders, the U.K. payment will equal the full credit payable to an individual U.K. resident, less 15 percent of the aggregate amount of the dividend and the U.K. payment. For U.S. tax purposes, the U.K. payment will be treated as an additional dividend and the 15 percent withholding will be considered a tax on the shareholder.

Effective dates.—We understand that if the revised treaty goes into effect, the United Kingdom will grant tax credits for the ACT, subject to 15 percent withholding, to U.S. resident individuals and other U.S. residents controlling less than 10 percent (i.e., "portfolio" investments) of the voting stock of a U.K. corporation in regard to dividends received for years beginning on or after April 6, 1973. For dividends received for any year beginning on or after April 6, 1975 by U.S. corporations controlling 10 percent or more (i.e., "direct" investments) of the voting stock of a U.K. corporation, the United Kingdom will make a payment of one-half of the ACT, less 5 percent withholding. For purposes of U.S. withholding taxes and most other treaty provisions, the revised treaty would generally be effective for years beginning on or after January 1, 1975.

"Associated Enterprises" and the Unitary Concept

Another new feature of the revised U.S.-U.K. treaty is the wording in Article 9(4), under the caption "Associated Enterprises," which deals with the methods by which a Contracting State or a political subdivision or local authority thereof may tax an enterprise which is controlled by an enterprise of the other Contracting State.

The limitations, in brief.—According to this provision, where an enterprise doing business in one Contracting State is a resident of the other Contracting State, or is controlled directly or indirectly by an enterprise which is a resident of the other Contracting State, the first-mentioned Contracting State or political subdivision or local authority thereof must abide by certain limitations on its taxing authority. Specifically, in determining the tax liability of the enterprise doing business within its borders, the taxing agency may not take into account the income, deductions, receipts, or outgoings of a related enterprise which is a resident of the other Contracting State, or of an enterprise of any third State which is related to the enterprise of the other Contracting State.

Exceptions.—There are several exceptions to this limitation. For example, the taxing jurisdiction in question may attribute income to the enterprise under the arm's-length principles followed by the U.S. federal taxing authority under Internal Revenue Code section 482. Also, where the enterprise which is a resident of the other Contracting State is a corporation, the limitations of Article 9(4) will apply only if that corporation (1) is not a "controlled foreign corporation" within the meaning of Code section 957, which defines such companies for purposes of current taxation of their U.S. shareholders in the case of certain undistributed "tax haven" income; (2) is not created or organized under the laws of the first-mentioned Contracting State or any third State; and (3) is not controlled, directly or indirectly, by a corporation which is a resident of any third State.

Further, the limitation of Article 9(4) will not apply where the enterprise doing business in a Contracting State is a resident of that state to the extent that it owns, directly or indirectly, the capital of a related enterprise.

Unitary apportionment.—The main reason for Article 9(4) is that some states in the United States—led by California and Oregon—have adopted the "unitary" method of apportioning business income taxes for state income tax purposes. Under this approach, a formula which typically involves sales, payroll, and property values is used to apportion business income. However, it is applied not only to the income of specific corporations operating in the state but also to any income of related corporations—including foreign affiliates—where the activities of the latter outside of the state are dependent upon or contribute to the corporation within the taxing state.

Although the inclusion of foreign income in the tax base of a company is normal practice by most state taxing authorities in the case of foreign branches, it is quite another matter in the case of affiliated corporations organized under the laws of foreign countries. The concern of the U.K. treaty negotiators about this controversial assertion of taxing jurisdiction by a few states here in the United States is the reason for Article 9(4).

SPECIFIC COMMENTS IN SUPPORT OF ARTICLES 10 AND (9)4

Although Articles 10 and 9(4) of the revised U.S.-U.K. income tax treaty are certainly not the only provisions which the Committee need review, they have become the key items in contention for the reasons already described. As further indicated below, we find the position of those state government officials who oppose Article 9(4) and thereby place Article 10 in jeopardy to be rather short-sighted if not altogether self-defeating.

ACT Credits for U.S. Shareholders (Article 10)

MAPI supports Article 10, as negotiated. As already noted, Article 10 on "Dividends" is the main reason for having renegotiated the 1945 treaty. Moreover, it is a necessary concession to U.S. residents who are investing in the United Kingdom, to put them more nearly in the same position as U.K. investors in U.K. corporations under the 1973 tax changes in that country.

Benefits of Article 10.—If a provision such as Article 10 were *not* to be made effective, the U.K. tax burden on dividends paid to U.S. shareholders would continue to be substantially greater than that with respect to dividends paid to local shareholders. The effect of such discriminatory taxation—if not corrected—is to lessen somewhat the desirability of new U.S. investments in the United Kingdom; to discourage the repatriation to U.S. shareholders of income from the U.K. corporations they now own; and to deny to the U.S. government some amount of revenues which might otherwise be derived from taxes levied on the dividend income in question. Also, the U.S. balance of payments is affected by tax treaty changes such as Article 10 which render more attractive the payment of dividends to U.S. owners of foreign corporations.

Although Article 10 does not do all that one might hope from a U.S. vantage point, it gains as much for U.S. corporate direct investors as the U.K. negotiators would yield and it does lessen the discrimination which otherwise exists. Also, the concession tends toward lessening the tax considerations which otherwise may affect decisions to pay out or retain income in the case of U.S.-controlled U.K. corporations. It is an objective of income tax treaties to reduce or eliminate tax impediments to international trade and investment, and Article 10 seems to us consistent with that purpose.

Article 10 as a precedent.—If Article 10 becomes effective, it will set an important treaty-negotiating precedent. The reason is that more and more of this country's major trading partners are eliminating their double taxes on distributed corporate income by integrating the income taxes assessed on dividends paid from corporations to their shareholders. In each case, they appear to be enacting measures to allow refundable tax credits to shareholders in respect of taxes already paid by corporations on the amounts distributed. However, these countries are generally excluding non-resident shareholders from these credit provisions. Examples—other than the United Kingdom—include Canada, France, and West Germany, and the U.S. treaty negotiators are encountering resistance in their efforts to revise our treaties to eliminate the resulting discrimination against U.S. investors.

If Article 10 becomes effective, it will point the way for similar or better relief provisions in treaties still to come. If Article 10 does not become effective, the fact that the United States and United Kingdom could not agree on the elimination of discrimination against foreign investors in this context will make the task more difficult for U.S. treaty negotiators in dealing with other countries.

"Associated Enterprises" (Article 9(4))

While it is perhaps understandable that the state governments would oppose any limitations on taxing jurisdiction they presently assert, we believe that those few governments which have adopted the unitary concept must, sooner or later, acknowledge its shortcomings.

Jurisdiction to tax.—First, as applied to the earnings of the foreign affiliates of a corporation doing business in a state, the unitary apportionment entails an extraordinary presumption of power to tax. Under unitary apportionment, a state may, in effect, tax the income of a foreign corporation even where it has conducted no business in the state and can demonstrate that any of its dealings with its affiliate within the state have been at arm's-length. Foreign govern-

ments consider the unitary concept to be overreaching, as would we if local taxpayers here were subjected to the same kind of income-siphoning by foreign governments.

In fact, taxing initiatives of this sort by state governments in our country may well lead to foreign tax and trade provisions which discriminate against U.S.-owned companies abroad, and against U.S. individual taxpayers stationed abroad. Certainly, our treaty negotiators find themselves inconvenienced in obtaining fair treatment for U.S. investors abroad when the negotiators for the other side can point to taxing practices here such as unitary apportionment. As indicated earlier, Article 9(4) was part of the consideration exacted by the U.K. treaty negotiators for Article 10. One wonders whether the discrimination against foreign investors by countries integrating their taxes on dividends is not in part a response to the taxing improprieties which their citizens encounter abroad.

Standard treaty policy on jurisdiction.—Further as to Article 9(4) and the unitary apportionment concept, the standard of tax jurisdiction embodied in U.S. tax treaties is that one Contracting State will not tax the business profits of an enterprise of the other Contracting State unless that enterprise does business in the first-mentioned state through a permanent establishment located there. The idea is to harmonize taxing jurisdictions at the national, state, and local levels by equating the tax base of an enterprise doing business in a state or political subdivision of the United States with the enterprise's federal income tax base. As already indicated, the unitary apportionment concept is inconsistent with this accepted tax treaty policy. Furthermore, it is our view that the U.S. tax and trade objectives embodied in the standard treaty policy with respect to jurisdiction are paramount in importance to the objectives of state governments following the unitary concept.

Minimal inconvenience to state governments.—We would add that the limitations imposed by Article 9(4) on a few state governments are minimal, as borne out by the many exceptions to the general limitation (described earlier). Furthermore, the treaty expressly recognizes the right of taxing agencies to determine the income among affiliates in a multinational group on the basis of an arm's-length standard. This standard, as embodied in Internal Revenue Code section 482, is internationally accepted, and is widely believed to be less arbitrary than unitary apportionment.

Administrative burden.—Another problem with unitary apportionment is the administrative burden which it places on corporate taxpayers, especially those which are foreign-owned. As described by the Task Force on Foreign Source Income of the House Committee on Ways and Means, a corporation in a "unitary" state has to obtain for that state's tax purposes the sales, income, property, and payroll figures for all its affiliates operating worldwide where the activities of those affiliates are dependent upon or contribute to the activities of the corporation within that state. Obviously, the compliance burden associated with this can be unreasonable.

As noted earlier, the Task Force included among its recommendations of March 8, 1977 one that the states precluded—for a variety of reasons, of which burden was only one—from taking into account, under the unitary method or any other method, the income of foreign affiliates or corporations doing business within the states until such time as that income is subject to federal income tax.

CONCLUDING COMMENT

In recommending that the Senate Foreign Relations Committee report favorably on the revised U.S.-U.K. income tax treaty, MAPI believes that an opportunity exists to begin the process of international tax harmonization in a tax area of increasing importance to savings and investment. We refer to the elimination of the double tax on distributed corporate income, an income tax reform which is increasingly gaining acceptance among the major trading nations and may eventually be adopted in this country, too. If it is not possible or practical for the legislatures of foreign governments to extend the benefits of this tax reform to foreign investors generally, along with domestic shareholders, then the alternative is to provide this equalization selectively in bilateral compacts. The revised U.S.-U.K. treaty is a landmark in this aspect of our overall program to reduce tax barriers to international trade, and we hope that the treaty will be ratified as is.

As for the few state governments which may dissent, we are of the view that they have more to gain from ratification of the treaty than from the position they espouse. In part, this is borne out by the public proceedings scheduled to take place soon in California to reconsider unitary apportionment in the wake of objections received from foreign investors and others about the practice. Whatever one may think of this type of apportionment in theory, it is in practice inconsistent with internationally recognized standards of taxing jurisdiction and can be duly burdensome to taxpayers. Indeed, unitary apportionment itself can be a tax impediment to trade and, to that extent, be a disservice to the Nation as a whole and to those state governments which use it. The limited curbs on this practice included in the treaty are, in our opinion, both appropriate and necessary.

We thank the Committee for this opportunity to present our views on the revised U.S.-U.K. income tax treaty.

Respectfully,

CHARLES STEWART,
President.

THE SECRETARY OF THE TREASURY,
Washington, D.C., February 15, 1977.

Mr. MARTIN HUFF,
Executive Officer,
California Franchise Tax Board,
Sacramento, Calif.

DEAR MR. HUFF: Thank you for your letter of January 24, 1977 and the copy of your letter to Secretary Vance, concerning objections to paragraph 4 of Article 9 of the proposed income tax treaty with the United Kingdom.

I understand your concern over this provision, but I cannot agree, after careful review of the issue, that the provision should be withdrawn from Senate consideration. I support the objective of the provision and furthermore, I feel that the Senate should be given the opportunity to voice its opinion.

I am sure that the arguments in support of the provision are familiar to you, but I would like to summarize them briefly.

The scope of the provision is quite limited. It will restrict the ability of California to include foreign affiliated corporations of a corporation doing business in California, only when that corporation is controlled by a U.K. corporation (which is in turn controlled by British shareholders). I am aware, as you state in your letter, that this does provide limited preferential treatment for U.K. based multinational corporations. You must bear in mind, however, that a treaty is a negotiated document containing a number of concessions by both partners. In the pending treaty, the United Kingdom made very important concessions, paritcularly in the treatment of dividends paid to U.S. investors. We view the Article 9(4) provision as an appropriate quid-pro-quo for the concessions made by the United Kingdom.

The unitary apportionment system is inconsistent with accepted tax treaty policy which prohibits one country from taxing the business profits of an enterprise of the other unless that enterprise is engaged in business through a permanent establishment in the first country. Under unitary apportionment, if the profit rate of a foreign member of a unitary group exceeds the profit rate of the member doing business in California, the effect is tantamount to taxing the profits of the foreign enterprise.

Though you state that unitary apportionment is "the most accurate and reasonable method yet devised" for assessing the income of one element in a multinational group, it is our experience, as well as that of most other countries, that the determination of income on the basis of an arm's-length standard is not only more accurate but also far less arbitrary. The arm's-length standard is the internationally accepted approach. Thus, in an international context, the use of another method by one jurisdiction will often lead to double taxation.

The unitary system imposes a substantial compliance burden on multinational corporations. Much of the information required for a combined report with respect to a foreign parent or foreign sister corporation may not be available to the taxpayer. Even where the information is available, the burden of reporting the accounts of many far-flung affiliates on a standardized basis can be great. We are aware of cases where this burden has discouraged foreign investment in the United States.

For all of these reasons, I repeat, the provisions of the proposed income tax treaty with the United Kingdom seem to me wholly appropriate and desirable.

Sincerely yours,

W. MICHAEL BLUMENTHAL.

GETTY OIL CO.,
Los Angeles, Calif., July 29, 1977.

Hon. JACOB JAVITS,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR JAVITS: Enclosed is the transcript of the hearings held before the California Franchise Tax Board on July 12, 1977 concerning the unitary method of taxation.

In view of the colloquy between yourself and Mr. Cory at the hearings on the United Kingdom Treaty on the 20th July, you may be interested in the exchange between Mr. Cory and Mr. Charles Walker (former Under Secretary of the Treasury) on page 173 through 176.

The Franchise Tax Board hearings contain a number of examples of the arbitrary and inequitable results produced by the unitary formula, particularly in the international area, and, accordingly, I submit the enclosed testimony for inclusion in the records of the hearings of the Senate Foreign Relations Committee on the United Kingdom Treaty.

Sincerely yours,

W. K. WOODSON.

Attachment.

EXCERPTS FROM HEARING, STATE OF CALIFORNIA FRANCHISE TAX BOARD

MEMBERS PRESENT

Mr. Kenneth Cory, State Controller, Chairman.
Mr. William M. Bennett, Member.
Mr. Roy M. Bell, Member.

MEMBERS ABSENT

None.

STAFF PRESENT

Mr. Martin Huff, Executive Officer.
Mr. Bruce W. Walker, Chief Counsel.
Mr. James W. Hamilton, Assistant Chief Counsel.
Mr. Benjamin F. Miller, Tax Counsel.
Ms. Anna M. Giuntini, Secretary.

ALSO PRESENT

Mr. Keith Seeigmiller, Deputy State Controller.

* * * * * * *

Board Member BENNETT. What does the government of Great Britain do for American corporations doing business there in exchange for this benefit we're giving their corporations?

Mr. WALKER. There are reciprocal provisions galore in the treaty that protect against double taxation, that provide for suitable tax credits. Indeed, perhaps the most significant as I think of it just offhand as you're talking to me is the provision in the treaty that classifies the petroleum revenue tax of Great Britain as a tax that is creditable in the United States against the U.S. tax liability. This permits——

Board Member BENNETT. But it doesn't diminish—doesn't take Great Britain on the tax, does it?

Mr. WALKER. Well, yes. Well——

Chairman CORY. This is really a wonderful benefit we've got, we people of America, we take it in the ear again.

Mr. WALKER. I'm sorry?

Chairman CORY. We take it in the ear again.

Mr. WALKER. On that?

Chairman CORY. Yes. We are going to give them a tax credit against the money they owe the U.S. Government, is what you said.

Mr. WALKER. Hold it, hold it. We are giving the U.S. taxpayer the certainty of getting a credit against his U.S. tax liability for the British tax that's paid.

Chairman CORY. That's right.

Mr. WALKER. OK.

Chairman CORY. The people take it in the ear again.

Mr. WALKER. No. This is a concept that assures the development of the oil interests over there with American capital, with American laborers, and with American investors.

Chairman CORY. And the United Kingdom taxes are deductible from the taxes that are rightfully due the United States of America.

Whoopee! Thanks folks.

Mr. WALKER. Well, this is——

Chairman CORY. Brought to you by those wonderful folks that gave us Watergate.

Mr. WALKER. Now Mr. Cory, you know that's an exaggeration.

Chairman CORY. You just cannot believe—it's quantum leaps forward in the emotion you feel against the unitary tax that I feel when corporations have the gall to come in here and say that's a benefit. That is a special interest piece of legislation put through in treaty form that is—if you tried to pass a piece of legislation through Congress, they'd run you out of town on a rail.

Mr. WALKER. Now, I believe you'll find that Congress is, on the subject of this British Petroleum tax, entirely enthusiastically and entirely supportive of it as a means of stimulating the development of resources of oil outside of the OPEC block. I think this is a highly significant element in the energy package, although that's a pretty digressed——

Board Member BENNETT. Well, that's laudable, and I'm sure everybody in the room commends that objective. But the effect of this treaty is to avoid the payment of certain taxes to the U.S. Treasury Department by American oil companies. Is that the effect of it? Do you understand the question?

Mr. WALKER. Yes. The effect of it is insure that there will be credit available for the British Petroleum tax against the U.S. tax liability.

Board Member BENNETT. What's this dollar benefit now that the American corporations get out of the taxing authority of Great Britain?

Mr. WALKER. The benefit the American companies get?

Board Member BENNETT. Well, I'm sure you in the Treasury Department wouldn't just give away that benefit without getting something back. You represent me, and all the taxpayers.

Mr. WALKER. We are getting back revenue from the oil companies that are operating over there. They are utilizing their capital resources that produce a return on their investment. They have employment of large dimensions that has worked in the United Kingdom in developing these resources, as well as to assure a supply of oil from that revenue.

I'm afraid we are disgressing just a little bit.

Board Member BENNETT. Without this tax policy you worked upon, the American oil companies would not have made those high bids for the privilege of exploring the North Sea.

Mr. WALKER. Well, this was—I believe, Mr. Bennett, as I mentioned I was not party to that negotiation.

Board Member BENNETT. Well, this just tells me that when the people from the Treasury Department indulge upon these great social purposes, they seldom look to the interests of the people they really represent.

Mr. WALKER. Well——

Board Member BENNETT. And Mr. Cory is quite right. I suggest to you, sir, that that came about because somebody walked into the Treasury Department, a special powerful interest, and got out of the Treasury Department at that time this kind of a treaty.

Mr. WALKER. Well, Mr. Bennett, you are certainly entitled to consider what you believe to be the way it happened.

Board Member BENNETT. Well, I think that's almost contemporary history. I think it's almost contemporary history. That's exactly the way the Bell legislation was gotten out of the Nixon White House.

RESOLUTION UNANIMOUSLY ADOPTED AT THE 45TH ANNUAL MEETING OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, HELD IN WILLIAMSBURG, VA., MAY 30–JUNE 3, 1977

RESOLUTION THIRTEEN

Whereas the Senate Committee on Foreign Relations has scheduled for public hearings on July 19–20, 1977, a Treaty which contains in Article 9, paragraph 4, provisions which prohibit states from continuing to use a fair and equitable method for determining the amount of income of a multinational corporation attributable to its activities occurring therein, and

Whereas the secretly negotiated Treaty for the first time in the nation's history restricts state taxing powers and creates a tax preference for mulinational corporations, and

Whereas such action disregards and overrides the continuing efforts of the several states to develop and perfect a uniform approach to determining the income of multistate and multinational corporations, now, therefore, be it

Resolved, by the National Association of Tax Administrators as follows:

1. That Resolution Eight, as unanimously adopted by the National Association of Tax Administrators at its Forty-fourth Annual Meeting on June 17, 1976, is reaffirmed.

2. That it oppose the unprecedented action adopted by the Executive Branch in secretly bargaining away the states' taxing powers, and in particular because such action benefits only the world's largest multinational corporations which have never established that they are exposed to tax on all of their income, nor that their effective tax rate is comparable to the tax rate imposed on local corporations.

3. That the National Association of Tax Administrators continue to oppose restrictive federal tax legislation with respect to multistate or mulinational taxpayers, and, if such legislaion is mandated, it should not provide preferential tax treatment for multinational corporations, should not permit such corporations to alter tax consequences by the corporate form through which they conduct their activities, nor allow the tax impact to be affected by the geographic location of the parent of a commonly owned group of corporations.

4. That copies of the Resolution be sent to the following: the President of the United States; the Governor of each state; the U.S. State Department; the U.S. Treasury Department, International Tax Section; the U.S. Senate Committee on Foreign Relations; and

5. That the Executive Secretary request permission to attend the public hearing regarding the treaty and urge that the parts thereof relating to state taxes be reserved.

OCTOBER 7, 1977.

HON. JEROME KURTZ,
Commissioner of Internal Revenue,
Washington, D.C.

DEAR MR. KURTZ: On June 28, 1977, I wrote President Carter urging a review of the Internal Revenue Service Rulings that permit payments made by multinational oil corporations to be credited against U.S. taxes owed by these companies. To continue to allow tax creditability status to oil company payments to OPEC countries is (a) bad tax policy, (b) inconsistent with the President's declared policy of reducing U.S. dependence upon the OPEC cartel, and (c) justified by no overriding foreign policy rationale.

On July 19, 1977, you testified before the Senate Foreign Relations Committee that the Internal Revenue Service was reviewing the status of the IRS rulings on the creditability of OPEC taxes on oil company operations. You stated the matter was complex and it might be several months before anything comprehensive was produced. And you assured me that the IRS was treating this as a "matter of great importance and high priority," one which you would keep your attention on "until it is resolved."

Several months have elapsed since that summer hearing, and the end of this session of Congress is rapidly approaching. No revenue ruling has been issued, and I have no word from the Internal Revenue Service as to when, or even if, such a ruling will be forthcoming. I ask that you promptly answer whether or not there will be such a revenue ruling and, if so, when it will issue.

Sincerely,

FRANK CHURCH,
Chairman, Subcommittee on Foreign Economic Policy.

DEPARTMENT OF THE TREASURY,
INTERNAL REVENUE SERVICE,
Washington, D.C., October 20, 1977.

DEAR MR. CHAIRMAN: I have been asked to acknowledge your October 7 letter to Commissioner Kurtz, requesting information concerning the creditability of OPEC taxes on oil company operations.

You will be further advised in the matter as soon as possible.

Sincerely yours,

ROBERT J. BRANN,
Chief, Technical Services Branch.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C., October 31, 1977.

Hon. FRANK CHURCH,
Chairman, Subcommittee on Foreign Economic Policy, U.S. Senate, Committee on Foreign Relations, Washington, D.C.

DEAR SENATOR CHURCH: This is in response to your inquiry, dated October 7, 1977, concerning the status of reconsideration by the Internal Revenue Service of the creditability of foreign taxes paid by oil companies to OPEC countries.

At the current time, our reconsideration is continuing. You have asked for the date that the Internal Revenue Service will publish the conclusions of our reconsideration. We cannot designate a certain date of publication until all our analysis has been completed and any conclusions of such analysis have been fully approved for publication.

I appreciate your interest in this matter and I assure you that you shall be advised of any anticipated publication.

With kind regards,

Sincerely,

JEROME KURTZ.

KENNETH CORY,
CONTROLLER OF THE STATE OF CALIFORNIA,
Sacramento, Calif., August 2, 1977.

Hon. JOHN SPARKMAN,
Chairman, Senate Foreign Relations Committee,
Washington, D.C.

A the hearings held on the proposed United States—United Kingdom Tax Treaty on July 19 and 20, concerns were expressed as to whether the United Kingdom would accept a reservation with respect to Article 9(4) of the Treaty or would disavow the Treaty.

For your consideration we submit this memorandum setting forth our views as to the overall economic considerations which are involved in the various important provisions of the Treaty. We are unaware of any overall economic evaluation that has been made available to the Committee, but from our review of available sources, the principal economic factors are:

1. THE RESTRICTION ON THE STATES TO USE THE UNITARY CONCEPT AS A RESULT OF ARTICLE 9(4)

No overall figures have been supplied as to the effect of Article 9(4) on the states. Testimony was presented at the hearing which indicated that the cost to Alaska on a yearly basis would be at least $10 million, applicable to the UK Treaty alone. California has made estimates based on the assumption that the language of Article 9(4) would be included in all future treaties and would be extended to all multinationals. California estimated its revenue loss for the year 1974 at at least $125 million. Clearly the economic value of rights being affected by the Treaty as applied to all the states is very large. The fact that a number of states do not presently fully exercise these particular rights should not be relevant to your consideration. No one would say that the right to free speech was of no importance even though one did not intend to exercise such right immediately.

Article 9(4) has no major impact on either the U.S. or the United Kingdom as governmental entities. The principal beneficiaries of this treaty provision are the multinational companies based in England and if the treaty is generalized,

multinational companies wherever located. The benefit these companies receive may result in a significant increase in their revenues and may provide some undeterminable, probably minor, benefit with respect to the business climate within the United States.

2. THE ALLOWANCE OF A CREDIT BY THE UNITED KINGDOM TO U.S. STOCKHOLDERS, CORPORATE AND INDIVIDUAL, OF PAYMENTS MADE TO THE UNITED KINGDOM UNDER THE ADVANCE CORPORATION TAX (ACT)

Testimony was presented at the hearings that the cumulative refund to U.S. shareholders would total $179 million, beginning with the year 1973, or approximately $35 to $40 million per year.

The Department of Inland Revenue of the United Kingdom bears the burden of this refund. The beneficiaries of this refund are United States-based investors, principally multinational corporations. There will be almost no effect upon the U.S. Treasury or state tax revenues because of the interaction of foreign tax credits and the deductibility or nondeductibility of foreign taxes.

The United Kingdom will undoubtedly realize some benefit as the result of a better business climate which will increase direct investment by U.S. investors. No doubt this is minor, considering the magnitude of international transactions.

3. THE CREDITABILITY OF THE UNITED KINGDOM PETROLEUM REVENUE TAX (PRT) AGAINST U.S. FEDERAL TAX LIABILITIES—DATA REGARDING NORTH SEA OIL RESERVES REFERRED TO BELOW IS FROM VARIOUS BUSINESS PUBLICATIONS

The estimate of recoverable petroleum reserves on the United Kingdom continental shelf has been placed between 21 and 33 billion barrels, not including large gas reserves. At current world prices, the potential production is worth in excess of $300 billion. Developmental problems are huge and will require tens of billions of dollars, high technology, and expertise which is available mainly from United States sources.

Allowing the PRT as a credit against federal tax will obviosly be a detriment to the United States Treasury. We have been unable to develop figures as to the cost involved. The PRT is apparently assessed at a rate of 45 percent after certain costs have been allowed as a deduction. With yearly production approaching 750 million barrels the loss to the U.S. Treasury will, we believe, exceed $100 million annually and will grow with production. The Treasury Department should be able to produce a more accurate estimate.

The primary beneficiaries of the allowance of the PRT as a credit are the U.S.-based multinational oil companies and, indirectly, the United Kingdom. The benefit to the United States-based companies is obvious and direct. Allowance of the tax as credit rather than a deduction increases the net return by approximately 100 percent. The United Kingdom benefits in that the allowance of the tax as a credit insures that North Sea investments will be economically attractive to U.S.-based companies when compared to their other options. The development of this resource is critical to the United Kingdom's continued economic survival.

We believe that Article 9(4) is insignificant when compared to the allowance of the PRT as a credit and the allowance of a credit by the United Kingdom with respect to the ACT. In comparing the three items, a reservation with respect to Article 9(4) would be immaterial as to the United Kingdom.

Finally, during my appearance before the committee, there was some discussion of the procedure used by the Treasury in deciding to include Article 9(4) in the Treaty. This is a clarification of the views expressed at the meeting.

My principal concern is that Article 9(4) was included in the Treaty without prior discussion by Treasury with the states or other interested parties. Mr. Woodworth's testimony that he had met with the states could only refer to the meeting held 18 months after the Treaty had been fully negotiated and approved by the President.

Of course, consideration of the methods by which states tax foreign-based corporations is appropriately for review by your committee. However, you must agree that the questions presented have ramifications in fields other than foreign policy, and deeply affect domestic tax and revenue policy. For that reason, I suggest that it would prove more appropriate in the long run to settle those questions by comprehensive legislation, involving both Houses of Congress in

the traditional process of discussion, debate and compromise of opposing interests. The current proposal, however, allows the Senate only the opportunity to approve or disapprove the action of the Executive Branch, and thus fails to take full advantage of the wisdom, experience and special knowledge of these matters available in the full deliberative processes of comprehensive legislation. Indeed, I am informed Mr. Woodworth has himself conceded that full legislative consideration would meet the requirements of foreign policy.

I again urge that Article 9(4) be reserved.

TABLE I.—TABLE OF EXTENT OF USE OF UNITARY CONCEPT BY STATES INCLUDED IN INDIANA SURVEY, PLUS ARIZONA, CONNECTICUT, AND MICHIGAN

State	Single corporation		Affiliated corporations		Foreign operations		Year
	Yes (34)	No (0)	Yes (32)	No (2)	Yes (24)	No (8)	
Alaska	X[1]		X[1]		X[2]		1973
Arizona[3]	X[4][1]		X[4][1]		X[5] (rarely)		1974
California	X[1] (1929)		X[1] (1936)		X[1] (1950's)		
Colorado[3]	X[1] (1967)		X[1] (1975)		X[1] (1976)		
Connecticut[3]	X[1]		X[1]		X[6]		1935
District of Columbia	X[7][1]		X[7][1]		X[7][1]		
Florida[3]	X[1]		X[1]			X	1972
Georgia	X[1]		X[8][2]			X	1973
Idaho	X[1]		X[1]		X[1]		1973
Indiana	X[9][1]		X[9][2]			X[7]	1978
Iowa	X[1] (1972)		X[1] (1972 consolidation.		X[1] (1972)		
Kansas	X[1] (July 1977)		X[1] (July 1977)		X[10] (July 1977)		
Kentucky[3]	X[11][2]		X[11][2]		X[11][2]		(12)
Louisiana	X[1] (1934)		X[13][2]			X	
Maine[3]	X[1] (1969)			X (1973)		X (1973)	
Massachusetts[3]	X[1] (1919)		X[2] (1919)		X[2] (1955)		
Michigan[3]	X[1][14]		X[1][14]			X[14]	1971
Minnesota[3]	X[1]		X[2]			X	1940
Mississippi	X[1]		(15)		(15)		
Missouri	X[1] (1930)		X[1] (August 1975).		X[1] (August 1975).		
Montana	X[1]		X[1]		X[1]		1972
Nebraska	X[1]		X[1]		X[1]		1968
New Mexico	X[16]		X[6]		X[16]		1969
New York	X[1]		X[17][2]			X	
North Carolina	X[1]		X[17][2]		X[19][2]		1957
North Dakota	X[1]		X[1]		X[1]		1973
Ohio[3]	X[1]		X[18][2]		X[20]		
Oklahoma	X[1]		X[1]		(21)		
Oregon	X[1]		X[1]		X[1]		
Tennessee	X[1]		X[2]		X[2][9]		1976
Utah	X[1] (1930)		X[1] (recent)		X (recent)		
Virginia[22]	X[1] (1962)		X (election consolidation).				
West Virginia	X[1]		X[1] (Federal consolidation).		X (Federal base).		1967
Wisconsin[3]	X[1]			X	X		

[1] Usually.
[2] Occasionally.
[3] Makes sec. 482 type adjustments.
[4] If gross income higher.
[5] If reflective of business activity.
[6] Only if the included corporations do business in the State.
[7] Only a few multistate and multinational corporations subject to tax.
[8] With permission.
[9] Accepts consolidated returns if all corporations are doing business in Indiana, and have accepted a few reports. Proposes to adopt unitary concept for single and multiple corporations for U.S. activities beginning in 1978.
[10] Western Hemisphere operations only.
[11] Occasionally at department's discretion.
[12] Past several years.
[13] Only as to DISC where income is considered that of parent.
[14] Through 1975, while corporate income tax imposed.
[15] Mississippi combines on a divisional basis in the absence of separate accounting records.
[16] At taxpayer's election.
[17] If manufacturing-selling and separate accounting does not reflect income.
[18] If transactions not at arm's length.
[19] Usually accepts petition for separate accounting.
[20] Only as to corporations doing business in the State.
[21] Intangible income taxed if a subsidiary of a corporation domiciled in State.
[22] Branches and possibly DISC corporations.
[23] For those corporations doing business in the State.

TABLE II—Corporate income tax States committed to worldwide combined reporting by Multistate Tax Commission Resolution

Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Missouri. Montana, Nebraska, New Mexico, North Dakota, Oregon, and Utah.

In computing corporate income, do you use the unitary concept for:

	Yes	If yes frequency—(usually) (occasionally)	No	When was your current practice adopted—year
(1) A single corporation				
(2) U.S. operations when conducted through more than one corporation				
(3) U.S. and foreign operations (whether conducted through a branch or a subsidiary either by audit practice or acceptance of returns).				
(4) Do you make Sec. 482 type adjustments with respect to related corporations.				

State

Who did you talk to

Title

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