INTERNATIONAL TAX TREATIES

HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

SIX INTERNATIONAL TAX TREATIES AND PROTOCOLS

JUNE 6, 1979

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INTERNATIONAL TAX TREATIES

WEDNESDAY, JUNE 6, 1979

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

The committee met, pursuant to notice, at 10:39 a.m., in room S–116, the Capitol, Hon. Frank Church (chairman of the committee) presiding.

Present: Senators Church, Stone, Javits, and Helms.

OPENING STATEMENT

Senator STONE [presiding]. The Chairman is upstairs, engaged in floor debate on a committee bill. Therefore, I will start this hearing and will read Senator Church's statement. When he returns from the floor, he will pick up on the continuity of the hearing.

REVIEW OF SIX INTERNATIONAL TAX TREATIES

We are here today to review six international tax treaties and protocols. In general, tax treaties are a vital element in minimizing the impediments to a free international flow of capital and technology. In addition, tax treaties serve to prevent situations in which a resident of one country is subject to double taxation. Tax treaties help to prevent unreasonable discrimination in the treatment of domestic and foreign investment. Finally, tax treaties are instrumental in the prevention of tax evasion and are important tools in the furtherance of international economic cooperation.

PROPOSED UNITED STATES-UNITED KINGDOM INCOME TAX TREATY

Of all the tax treaties before this committee, the one that has received the most attention is the proposed Income Tax Treaty between the United States and the United Kingdom. During the 95th Congress, this tax treaty was approved by the Senate, but a reservation that our Chairman, Senator Church, proposed was attached to the State taxation provision. I am satisfied that the new protocol takes into account his objection to the provisions of article 9(4). The protocol deletes the proposed restriction on State taxation, thus enabling the States to continue to tax United Kingdom corporations in keeping with their constitutional prerogatives. Ratification of last year's treaty is contingent upon Senate ratification of the protocol.

CONCERNS RAISED BY INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS

Several other changes are contemplated in the protocol. These changes are explained in the appropriate committee documents. We understand, however, that an expression of concern has been raised by the International Association of Drilling Contractors (IADC). It objects to the provision of the United Kingdom protocol which amends the proposed treaty to make it clear that the United Kingdom will not be barred under the treaty from taxing the income derived by the independent drilling contractors from their operations in the United Kingdom sector in the North Sea. We will hear a representative of the IADC this morning.

PROTOCOL TO UNITED STATES-FRANCE INCOME TAX TREATY

The committee has not received any objections to any of the provisions of the other tax treaties. The protocol to the existing United States-France Income Tax Treaty is designed to account for the changes in the French taxation method for Americans residing in France. It is important to note that failure to act on the French protocol before December 31, 1979, could result in double taxation for many of the U.S. citizens in France.

The remaining tax treaties that will be considered are the following: The United States-France Estate and Gift Tax Treaty, the United States-United Kingdom Estate and Gift Tax Treaty, the United States-Hungary Income Tax Treaty, and the United States-South Korea Income Tax Treaty.

We strongly urge that the committee attempt to act upon these tax treaties this morning after hearing from our distinguished witnesses. As you probably know, the committee schedule is extremely busy. The upcoming consideration of the SALT Treaty will render review of the tax treaties very difficult at a later time.

Our first witness this morning is the Honorable Charles McC. Mathias, Jr., of the State of Maryland.

Senator Mathias, welcome to the committee.

STATEMENT OF HON. CHARLES McC. MATHIAS, JR., A U.S. SENATOR FROM MARYLAND

Senator MATHIAS. Thank you very much, Mr. Chairman.

Let me begin by performing the very pleasant function of introducing to the committee our colleague Marlow Cook, the distinguished former Senator from Kentucky. I would also introduce a legislative colleague from London, a Member of the Parliament of Great Britain, the Right Honorable Michael Grylls, whose presence I am sure the committee would like to acknowledge.

Senator STONE. Senator Cook, welcome.

Mr. Grylls, we are indeed happy to have you here with us today.

ISSUE OF UNITARY TAXATION AND WORLDWIDE COMBINATION

Senator MATHIAS. I am grateful for this opportunity to talk very briefly and very informally on the issue of unitary taxation and

worldwide combination by the various States within our own Union. Under this method of taxation, the States can tax companies doing business in interstate and foreign commerce on the basis of their worldwide income rather than on that portion of it which is derived from activities within the taxing State.

ARTICLE 9(4) OF UNITED STATES-UNITED KINGDOM TAX TREATY

As the chairman is well aware, the United States-United Kingdom Tax Treaty, as it was originally negotiated, contained article 9(4), which was a provision that would have limited the ability of the States to adopt a system of taxation based on the unitary concept.

Article 9(4), however, was eliminated on the Senate floor last year by the Church reservation. Perhaps in retrospect that may have been for the best. Today I would like to talk about the article 9(4) issue, not to argue that we should go back and alter the treaty again, but rather to urge the committee to support my independent effort to address the problem legislatively.

S. 983—INTERSTATE TAXATION BILL

I have introduced S. 983, and I have a small supply of this bill for the committee and for anyone else who might like to have a copy. We call it the interstate taxation bill. This bill, in section 303, would accomplish for all nations what the negotiators attempted to achieve in article 9(4) for the United Kingdom alone.

During the Senate debate on the United States-United Kingdom Tax Treaty, many House members spoke to me about the possibility of substituting this bill for article 9(4) of the treaty. They wanted a chance to address the issues that were raised by that article, and a legislative approach would provide that opportunity. The treaty approach left the House out in the cold.

I note from the hearings before the Foreign Relations Committee that even those who opposed article 9(4) expressed the view that the Congress ought to act legislatively to address this problem. The legislative approach has several advantages. It will resolve the problem across the board, rather than on a piecemeal, treaty-by-treaty basis. Not only the United Kingdom, but our other trading partners all around the world, have indicated a strong desire for protection from inconsistent tax treatment by States which exposes their companies to the risk of double taxation. This is more than a theoretical risk.

Senator STONE. Senator, if you would like, I think the committee could usefully include a copy of your bill and any other materials explaining your bill in the committee hearing record at this point.

Senator MATHIAS. I thank you very much, Mr. Chairman. I will submit a copy of the bill for that purpose.

[The information referred to follows:]

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled. That this Act may be cited as the "Interstate Taxation Act of 1979".

TITLE I—SALES AND USE TAXES

PART A—JURISDICTION AND ADMINISTRATION

SEC. 101. UNIFORM JURISDICTIONAL STANDARDS.

(a) STATE STANDARD.—No State shall have power to require a person to collect a sales or use tax with respect to a sale or use of tangible personal property unless that person—

(1) has a business location in that State, or

(2) regularly solicits orders for the sale of tangible personal property by means of salesmen, solicitors, or representatives in that State, unless his activity in that State consists solely of solicitation by direct mail or advertising by means of printed periodicals, radio, or televison, or

(3) regularly engages in the delivery of tangible personal property in that State other than by common carrier or United States Postal Service.

(b) POLITICAL SUBDIVISION STANDARD.—No political subdivision of a State shall have power to require a person to collect a sales or use tax with respect to a sale or use of tangible personal property unless that person—

(1) has a business location in that political subdivision, or

(2) regularly solicits orders for the sale of tangible personal property by means of salesmen, solicitors, or representatives in that political subdivision, unless his activity in that political subdivision consists solely of solicitation by direct mail or advertising by means of printed periodicals, radio, or television, or

(3) regularly engages in the delivery of tangible personal property in that political subdivision other than by common carrier or United States Postal Service.

(c) FREIGHT CHARGES INCIDENT TO INTERSTATE SALES.—Where the freight and other charges for transporting tangible personal properly to a purchaser incident to an interstate sale are not included in the purchase price but are stated separately by the seller, no State or political subdivision thereof shall have power to include such charges in the measure of a sales or use tax imposed with respect to the sale or use of such property.

SEC. 102. REDUCTION OF MULTIPLE TAXATION.

(a) DESTINATION IN STATE; COOPERATIVE AGREEMENTS BETWEEN STATES.—A State may impose a sales tax or require a seller to collect a sales or use tax with respect to an interstate sale of tangible personal property only if the destination of the sale is—

(1) in that State, or

(2) in a State or political subdivision for which the tax is required to be collected by an agreement between the State of destination and the State requiring such collection, and the seller has a business location in the State requiring such collection.

(b) DESTINATION IN POLITICAL SUBDIVISION.—A political subdivision of a State may impose a sales tax or require a seller to collect a sales or use tax with respect to an interstate sale of tangible personal property only if the destination of the sale is in that political subdivision.

(c) LIMITATION.— Not withstanding section 101 and subsections (a) and (b) of this section, no State or political subdivision thereof shall have power to require an out-of-State seller to collect a sales or use tax with respect to an interstate sale of tangible personal property with a destination in that State if such seller's annual receipts from taxable retail sales of tangible personal property with a destination in that State are less than $20,000, except that this limitation shall not be effective is the extent that such seller has, in fact, collected a separately stated sales or use tax from the purchaser. In determining whether the foregoing limitation applies, an out-of-State seller shall be deemed to have less than $20,000 in annual receipts from taxable retail sales or tangible personal property with a destination in a State if such seller's receipts from such sales during the preceding calendar year did not exceed $20,000.

(d) CREDIT FOR PRIOR TAXES.—The amount of any use tax imposed by a State or political subdivision thereof with respect to tangible personal property shall

be reduced by the amount of any sales or use tax previously paid by the taxpayer with respect to the same property on account of liability to another State or political subdivision thereof.

(e) REFUNDS.—A person who pays a use tax imposed with respect to tangible personal property shall be entitled to a refund from the State or political subdivision thereof imposing the tax, up to the amount of the tax so paid, for any sales or use tax subsequently paid to the seller with respect to the same property on account of prior liability to another State or political subdivision thereof.

(f) VEHICLES, BOATS AND MOTOR FUELS.—

(1) VEHICLES AND BOATS.—Nothing in subsection (a) or (b) shall affect the power of a State or political subdivision thereof to impose or require the collection of a sales or use tax with respect to motor vehicles and boats registered in that State.

(2) FUELS.—Nothing in this section shall affect the power of a State or political subdivision thereof to impose or require the collection of a sales or use tax with respect to motor fuels consumed in that State.

SEC. 103. SALES TO REGISTERED BUSINESS PURCHASER; EXEMPT SALES CERTIFIED AS SUCH BY PURCHASER.

No seller shall be liable for the collection or payment of a sales or use tax with respect to an interstate sale of tangible personal property if the purchaser of such property furnishes or has furnished to the seller—

(1) a statement indicating that the purchaser is registered with the jurisdiction imposing the tax to collect or pay such tax, or

(2) a certificate or other form of evidence indicating the basis for exemption or other reason the seller is not required to collect or pay such tax.

Any statement, certificate or other form of evidence furnished for purposes of paragraph (1) or (2) shall be in writing, shall give the name and address of the purchaser and his registration number, if any, and shall be signed by the purchaser or his representative. Nothing in this section shall limit the liability of a seller who, at the time of receipt of a statement, certificate or other form of evidence furnished by a purchaser for purposes of paragraph (1) or (2), has actual knowledge that such document is false or inaccurate.

SEC. 104. SALES BY CERTAIN OUT-OF-STATE SELLERS.

(a) ELECTION TO COLLECT TAX CERTIFIED BY PURCHASER.—With respect to any calendar year, an out-of-State seller who has less than $100,000 annually in taxable sales of tangible personal property with a destination in a State may in lieu of collecting any sales or use tax which that State or a political subdivision thereof may require to be collected under sections 101 and 102, elect to collect and remit to that State a combined State and local sales or use tax at a rate or in an amount which shall be certified to such seller by the purchaser as being the correct rate or amount applicable to the sale. Any such certification shall be in writing, shall give the name and address of the purchaser and his registration number, if any, and shall be signed by the purchaser or his representative. Nothing in this section shall limit the liability of an out-of-State seller who has made an election under this subsection and who, at the time of receipt of a purchaser's certification of the correct rate or amount tax applicable to an interstate sale with a destination in a State to which such election applies, has actual knowledge that such certification is false or inaccurate.

(b) FAILURE OF PURCHASER TO CERTIFY CORRECT RATE OR AMOUNT OF TAX.—If an election under subsection (a) is in effect with respect to a State, and a purchaser in that State who purchases tangible personal property from the electing out-of-State seller fails or refuses to certify to such seller the correct rate or amount of sales or use tax applicable to the sale, such sale shall collect and remit the highest combined State and local sales or use tax which could imposed with respect to any interstate sale having a destination in that State and shall in no way be liable to such purchaser for any excess of the tax so collected over the correct amount of tax applicable to the sale.

(c) DETERMINATION OF ANNUAL TAXABLE SALES IN A STATE.—For purposes of determining whether an out-of-State seller is eligible to make an election under subsection (a) with respect to any calendar year, such seller shall be deemed to have less than $100,000 annually in taxable sales of tangible personal property with a destination in a State if such seller's receipts from such sales during the preceding calendar year did not exceed $100,000.

(d) ADMINISTRATION.—No State may require an out-of-State seller who elects under subsection (a) to collect combined State and local sales and use taxes pursuant to purchasers' certifications of the correct rates or amounts of such taxes

to remit the taxes so collected more frequently than once each calendar quarter. A State may require such a seller to maintain such records, certifications and other information as may be necessary for the proper administration of such taxes, but may not require such a seller to classify or otherwise account for the sales to which such taxes relate according to geographic areas of that State in any manner whatsoever, including classification by political subdivision.

(e) STANDARD FORM OF RETURN.—The Secretary of Commerce of the United States shall prescribe a standard form of return for the combined State and local sales and use taxes collected by an out-of-State seller who has made an election under subsection (a), and no State or political subdivision thereof may require such seller to file, with respect to such taxes, a form of return other than such standard form. The filing of a certified duplicate copy of such standard form incorporating the information required for all States with respect to which such seller has made an election under subsection (a) shall be accepted in lieu of the filing of a separate return for each such State.

SEC. 105. ACCOUNTING FOR LOCAL TAXES.

No seller shall be required by a State or political subdivision thereof to classify interstate sales for sales or use tax accounting purposes according to geographic areas of that State in any manner other than to account for interstate sales with destinations in political subdivisions in which the seller has a business location or regularly makes household deliveries.

SEC. 106. SAVINGS PROVISIONS.

(a) USE TAXES.—Nothing in this Act shall prohibit a State or political subdivision thereof from imposing and collecting a use tax from a purchaser or user with respect to the use in that State or political subdivision of tangible personal property—

(1) acquired in an interstate sale from an out-of-State seller who is not required to collect such a tax with respect to such sale, or

(2) acquired outside that State or political subdivision and brought into that State or political subdivision by such purchaser or user.

(b) CORRECT TAX NOT COLLECTED.—Nothing in this Act shall prohibit a State or political subdivision thereof from collecting a sales or use tax from a person who purchases tangible personal property in an interstate sale if for any reason, including an incorrect or invalid certification or representation made by such purchaser with respect to the tax-exempt status of such sale or, in the case of a purchase from an out-of-State seller having made an election under section 104(a), with respect to the correct rate or amount of tax applicable to such sale, the seller has not collected the correct amount of sales or use tax from such purchaser. This subsection shall not apply if the seller has collected the correct amount of tax from the purchaser but has failed to remit such tax to the State.

(c) CERTAIN ADVANCE PAYMENTS.—Nothing in this Act shall prohibit a State or political subdivision thereof from requiring a purchaser of tangible personal property for resale to make an advance payment of a sales or use tax to the seller of such property, or from requiring such seller to act as agent for such State or political subdivision and in that capacity to collect and remit such advance payment, provided that credit for such advance payment is allowed in determining the sales or use tax liability of the purchaser and provided that all the foregoing requirements are imposed pursuant to laws of such State or political subdivision which were in effect in December 31, 1974.

SEC. 107. LIABILITY WITH RESPECT TO UNASSESSED TAXES.

(a) PERIODS ENDING PRIOR TO ENACTMENT DATE.—No State or political subdivision thereof shall have the power, after the date of the enactment of this Act, to assess against any person for any period ending on or before such date in or for which that person became liable for the tax involved, a sales or use tax with respect to tangible personal property, unless during such period that person—

(1) had a business location in that State, or

(2) regularly solicited orders for the sale of tangible personal property by means of employees present in that State, unless his activity in that State consisted solely of solicitation by direct mail or advertising by means of printed periodicals, radio, or television, or

(3) regularly engaged in the delivery of tangible personal property in that State other than by common carrier or United States Postal Service.

(b) CERTAIN PRIOR ASSESSMENTS AND COLLECTIONS.—The provisions of subsection (a) shall not be construed—

(1) to invalidate the collection of a tax prior to the time assessment became barred under subsection (a), or

(2) to prohibit the collection of a tax at or after the time assessment became barred under subsection (a), if the tax was assessed prior to such time.

PART B—DEFINITIONS AND RULES

SEC. 151. SALES TAX; SALES PRICE.

A "sales tax" is any tax imposed with respect to, and measured by the sales price of, the sale of tangible personal property or services with respect to such a sale, and which tax is required by State law to be stated separately from the sales price by the seller or is customarily stated separately from the sales price. The term "sale" includes any lease or rental of tangible personal property and the term "sales price" includes receipts from any such lease or rental.

SEC. 152. USE TAX.

A "use tax" is any nonrecurring tax, other than a sales tax, which is imposed on or with respect to the exercise or enjoyment of any right or power over tangible personal property incident to the ownership of that property or the leasing of that property from another, including any consumption, keeping, retention, or other use of tangible personal property.

SEC. 153. INTERSTATE SALE.

An "interstate sale" means a sale in which the tangible personal property sold is shipped or delivered to the purchaser in a State from a point outside that State.

SEC. 154. STATE.

The term "State" wherever used in this Act means the District of Columbia or any of the fifty States of the United States.

SEC. 155. DESTINATION.

The "destination" of a sale is in the State or political subdivision in which possession of the property is physically transferred to the purchaser, or to which the property is shipped to the purchaser regardless of the rate on board point or other conditions of the sale.

SEC. 156. OUT-OF-STATE SELLER.

An "out-of-State seller" with respect to any State is a seller who does not have a business location in that State.

SEC. 157. BUSINESS LOCATION.

A person shall be considered to have a "business location" within a State only if that person—

(1) owns or leases real property within that State, or

(2) has one or more employees located in that State, or

(3) regularly maintains a stock of tangible personal property in that State for sale in the ordinary course of his business.

For purposes of paragraph (3), property which is on consignment in the hands of a consignee and is offered for sale by such consignee shall not be considered as stock maintained by the consignor, and property which is in the hands of purchaser under a sale or return arrangement shall not be considered as stock maintained by the seller.

SEC. 158. LOCATION OF PROPERTY.

Property shall be considered to be located in a State if it is physically present in that State.

SEC. 159. LOCATION OF EMPLOYEE.

(a) GENERAL RULE.—An employee shall be considered to be located in a State if—

(1) the service of such employee is localized in that State, or

(2) the service of such employee is not localized in any State but some of such service is performed in that State and such employee's base of operations is in that State.

(b) LOCALIZATION OF SERVICE.—An employee's service shall be considered to be localized in a State if—

(1) such service is performed entirely within that State, or

(2) such service is performed both within and without that State, but the service performed without that State is incidental to the service performed within that State.

(c) BASE OF OPERATION.—An employee's base of operations is that single place of business, having a permanent location, which is maintained by his employer, and from which he regularly commences his activities and to which he regularly returns in order to perform the functions necessary to the exercise of his trade or profession.

(d) CONTINUATION OF MINIMUM JURISDICTIONAL STANDARD.—An employee shall not be considered to be located in a State if his business activities within that State on behalf of his employer are limited to any one or more of the following:

(1) The solicitation of orders for sales of tangible personal property, which orders are sent outside that State for approval or rejection and (if approved) are filled by shipment or delivery from a point outside the State.

(2) The solicitation of orders for sales of or for the benefit of a prospective customer of his employer, if orders by such customer to such employer to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

(3) The installing or repairing of tangible personal property which is the subject of an interstate sale by the employer, if such installation or repair is incidental to the sale. This subsection shall not apply with respect to business activities carried on by one or more employees within a State if the employer (without regard to those employees) has a business location in that State.

(e) EMPLOYEES OF CONTRACTORS AND EXTRACTORS.—If the employer is engaged in the performance of a contract for the construction of improvements on or to real property in a State or of a contract for the extraction of natural resources located in a State, an employee whose services in that State are related primarily to the performance of such contract shall be presumed to be located in that State. This subsection shall not apply with respect to services performed in installing or repairing tangible property which is the subject of an interstate sale by the employer, if such installation or repair is incidental to the sale.

(f) EMPLOYEE.—No person shall be considered an employee of an employer unless such person is an employee of such employer for purposes of Federal income tax withholding under chapter 24 of the Internal Revenue Code of 1954, as amended.

SEC. 160. HOUSEHOLD DELIVERIES.

A seller makes household deliveries in a State or political subdivision if he delivers goods, otherwise than by common carrier of United States Postal Service, to the dwelling place of his purchasers located in that State or political subdivision.

SEC. 161. LIMITATION ON APPLICABILITY

Except as otherwise expressly provided in this Act, the definitions and rules set forth in this part shall apply only for purposes of this title.

TITLE II—GROSS RECEIPTS TAXES

PART A—JURISDICTION

SEC. 201. UNIFORMED JURISDICTIONAL STANDARDS.

No State or political subdivision thereof shall have power to impose a gross receipts tax with respect to the interstate sale of tangible personal property unless the sale is solicited directly through a business office of the seller in the State or political subdivision.

SEC. 202. SAVINGS PROVISION.

Nothing in this Act shall prohibit a State or political subdivision thereof from imposing and collecting a gross receipts tax on activities occurring entirely within that State or political subdivision, including any tax imposed with respect to the extraction of oil, coal, minerals or other natural resources located within that state or political subdivision.

PART B—DEFINITIONS

SEC. 251. GROSS RECEIPTS TAX.

For purposes of this title, a "gross receipts tax" is any tax, other than a sales tax, which is imposed on or measured by the gross volume of business (whether

in terms of gross receipts or in other terms), which is applicable to commercial or manufacturing business in general, and in the determination of which no deduction is allowed which would constitute the tax a net income tax.

SEC. 252. BUSINESS OFFICE.

For purposes of this title, a seller shall be considered to have a "business office" in a State or political subdivision only if that seller—

(1) owns or leases real property within that State or political subdivision, or

(2) regularly maintains a stock of tangible personal property in that State or political subdivision for sale in the ordinary course of his business.

For purposes of paragraph (1), a seller shall not be considered as owning or leasing real property which is owned or leased by that seller's employee, unless that seller pays the costs of owning or leasing such property.

For purposes of paragraph (2), property which is on consignment in the hands of a consignee and is offered for sale by such consignee on his own account shall not be considered as stock maintained by the consignor, and property which is in the hands of a purchaser under a sale or return arrangement shall not be considered as stock maintained by the seller.

SEC. 253. OTHER DEFINITIONS.

For purposes of this title, the terms "sales tax", "State", and "interstate sale" have the same meaning as such terms have for purposes of title I of this Act, and the term "net income tax" has the same meaning as such term has for purposes of title III of this Act.

TITLE III—NET INCOME TAXES

PART A—APPORTIONABLE AND ALLOCABLE INCOME

SEC. 301. OPTIONAL THREE-FACTOR FORMULA

A State or political subdivision thereof may not impose for any taxable year on a corporation taxable in more than one State, other than an excluded corporation, a net income tax measured by an amount of net income in excess of the amount determined by (1) multiplying the corporation's base by an apportionment fraction which is the average of the corporation's equally-weighted property, payroll and sales factors for that State for the taxable year and (2) adding to the amount determined under clause (1) the amount of income allocable to that State for the taxable year. For this purpose the base to which the apportionment fraction is applied shall be the corporation's apportionable income as defined in this title for that taxable year. No State shall, by reason of not including dividends of foreign source income in apportionable income, make any offsetting adjustment of an otherwise allowable deduction which is unrelated to such excluded dividends or foreign source income.

SEC. 302. INCOME ALLOCABLE TO A STATE; EXCLUSIONS FROM APPORTIONABLE AND ALLOCABLE INCOMES.

Dividends received from corporations in which the taxpaying corporation owns less than 50 percent of the voting stock, other than dividends which constitute foreign source income, are income allocable to the State of commercial domicile of such taxpaying corporation and are not apportionable or allocable to any other State. No dividends received from corporations in which the taxpaying corporation owns 50 percent or more of the voting stock and no foreign source income of such taxpaying corporation shall be apportionable or allocable to any State.

SEC. 303. COMBINED OR CONSOLIDATED REPORTING.

(a) Except as otherwise provided in subsection (b), a State may require, or a corporation may elect, that the taxable income of the corporation be determined by reference to the combined or consolidated net income and the combined or consolidated apportionment factors of all affiliated corporations in the affiliated group of which the corporation is a member.

(b) For purposes of subsection (a), no State may require, and no corporation may elect, that a combination or consolidation of an affiliated groups include—

(1) any excluded corporation, or

(2) any corporation, substantially all the income of which is derived from sources without the United States.

For purposes of paragraph (2), substantially all the income of a corporation (whether a domestic or a foreign corporation) shall be deemed to be derived from

sources without the United States if 80 percent or more of its gross income is derived from sources without the United States in the current taxable year and in each of the two preceding taxable years (excluding any period during which such corporation was not in existence).

(c) Nothing in this title shall preclude the determination of combined or consolidated income on a basis acceptable to both the State and the taxpaying corporation.

PART B—DEFINITIONS AND RULES

SEC. 351. NET INCOME TAX.

A "net income tax" is a tax which is imposed on or measured by net income.

SEC. 352. EXCLUDED CORPORATION.

An "excluded corporation" is any of the following:

(1) Any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, small loan association, credit union, cooperative bank, small loan company, sales finance company, or investment company, or any type of insurance company, or any corporation which derives 90 percent or more of its gross income from interest (including discount).

(2) Any corporation more than 50 percent of the ordinary gross income of which for the taxable year is derived from regularly carrying on any one or more of the following business activities:

(A) the transportation for hire of property or passengers, including the rendering by the transporter of services incidental to such transportation;

(B) the sale of electrical energy or water; or

(C) the furnishing of public telegraph or intrastate telephone services.

SEC. 353. AFFILIATED CORPORATIONS.

Two or more corporations are "affiliated" if they are members of the same groups composed of one or more corporate members connected through stock ownership with a common owner, which may be either corporate or noncorporate, in the following manner:

(1) more than 50 percent of the voting stock of each member other than the common owner directly by one or more of the other members; and

(2) more than 50 percent of the voting stock of at least one of the members other than the common owner is owned directly by the common owner.

SEC. 354. APPORTIONABLE INCOME.

Except to the extent otherwise provided in section 301 or section 302, the "apportionable income" of a corporation means its net income subject to apportionment as determined under the laws of the taxing State.

SEC. 355. PROPERTY FACTOR.

(a) IN GENERAL.—A corporation's property factor for any State is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned and used or rented and used during the taxable year and located in that State and the denominator of which is the average value of all the corporation's real and tangible personal property owned and used or rented and used during the taxable year and located everywhere, except that such denominator shall not include any property which the State or the corporation determines to exclude pursuant to section 358(c).

(b) STANDARDS FOR VALUING PROPERTY IN PROPERTY FACTOR.—

(1) OWNED PROPERTY.—Property owned by the corporation shall be valued at its original cost.

(2) RENTED PROPERTY.—Property rented to the corporation shall be valued at eight times the net rents payable by the corporation during the taxable year. Net rent is the gross rent payable by the corporation less rent received by the corporation from subrentals.

SEC. 356. PAYROLL FACTOR.

(a) IN GENERAL.—A corporation's payroll factor for a State is a fraction, the numerator of which is the amount of wages paid or accrued during the taxable year by the corporation to employees located in that State and the denominator of which is the total amount of wages paid or accrued during the taxable year by the corporation to all employees located everywhere, except that such denominator shall not include any wages which the State or the corporation determines to exclude pursuant to section 358(c).

(b) DEFINITION OF WAGES.—The term "wages" means wages as defined for purposes of the Federal Unemployment Tax Act in section 3306(b) of the Internal Revenue Code of 1954, as amended, determined without regard to the limitation of section 3306(b)(1) on the amount of wages.

SEC. 357. SALES FACTOR.

(a) IN GENERAL.—A corporation's sales factor for a State is a fraction, the numerator of which is the total sales of the corporation in that State during the taxable year and the denominator of which is the total sales of the corporation everywhere during the taxable year, except that such denominator shall not include any sales which the State or the corporation determines to exclude pursuant to section 358(c).

(b) SALES INCLUDED.—

(1) Sales of tangible personal property are in a State if such property is received in that State by the purchaser. In the case of delivery by common carrier or by other means of transportation, the place at which such property is ultimately received after all transportation has been completed shall be considered as the place at which such property is received by the purchaser. Direct delivery in a State, other than for purposes of transportation, to a person or firm designated by a puchaser constitutes delivery to the purchaser in that State and direct delivery outside a State to a person or firm designated by a purchaser does not constitute delivery to the purchaser in that State, regardless of where the title passes or other conditions of sale.

(2) Sales, other than sales of tangible property, are in a State if—

(A) the income-producing activity is performed in that State, or

(B) the income-producing activity is performed both in and outside that State and a greater proportion of the income-producing activity is performed in that State than in any other State, based on costs of performance.

(c) LOCATION OF CERTAIN OTHER SALES.—

(1) Sales of services shall be included in the numerator of the sales factor for the State in which the service is performed. Sales of services rendered in two or more States shall, for the purpose of the numerator of the sales factor, be divided between those States in proportion to the direct costs of performance incurred in each such State by the corporation in rendering the services.

(2) Sales of real property, if the corporation is engaged primarily in the business of selling real property, are included in the numerator of the sales factor for the State in which the property is located.

(3) Sales which consist of receipts from the rental of tangible personal property shall be included in the numerator of the sales factor for the State in which the property is located.

(d) ALL OTHER SALES.—All gross receipts from sales, other than from the sales described in subsections (b) (c), shall be excluded from both the numerator and the denominator of the sales factor.

SEC. 358. FOREIGN SOURCE INCOME.

(a) DEFINITION.—The term "foreign source income" means—

(1) interest other than interest derived from sources within the United States;

(2) dividends other than dividends derived from sources within the United States;

(3) rents, royalties, license and technical fees from property located or services performed without the United States or from any interest in such property, including rents, royalties or fees for the use of or the privilege of using without the United States any patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties; and

(4) gains, profits, or other income from the sale of intangible or real property located without the United States.

(b) DETERMINATION OF SOURCE OF INCOME BY REFERENCE TO PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954.—In determining the source of income for purposes of this section and section 303(b), the provisions of sections 861, 862 and 863 of the Internal Revenue Code of 1954, as amended, shall be applied.

(c) ADJUSTMENT OF PROPERTY, PAYROLL, OR SALES FORCE.—If foreign source income as defined for purposes of this title is derived from property, wages or sales which are otherwise includable in the denominator of a factor described in section 355, 356 or 357, either the State or the corporation may determine that the property, wages or sales from which such foreign source income is derived shall be excluded from such denominator.

SEC. 359. DIVIDENDS.

The term "dividends" shall have the same meaning as that term has under the Internal Revenue Code of 1954, as amended, including any sum treated as a dividend under section 78 of such Code.

SEC. 360. UNITED STATES.

The term "United States" wherever used in this Act shall include only the fifty States and the District of Columbia.

SEC. 361. LIMITATION ON APPLICABILITY.

Except as otherwise expressly provided in this Act, the definitions and rules set forth in this part shall apply only for purposes of this title.

TITLE IV—JURISDICTION OF FEDERAL COURTS

SEC. 401. JUDICIAL REVIEW.

Notwithstanding section 1251(a) of title 28, United States Code, the United States Court of Claims shall have jurisdiction to review de novo any issues relating to a dispute arising under this Act or under the provisions of Public Law 86-272, as amended. Within 90 days of the decision of a State administrative body from which the only appeal is to a court, any party to the determination may petition the Court of Claims for a review de novo of any such issues. For purposes of such review, the findings of fact by the State administrative body shall be considered with other evidence of the facts. The judgment of the Court of Claims shall be subject to review by the Supreme Court of the United States as provided in section 1255 of title 28, United States Code as amended.

SEC. 402. EFFECT OF FEDERAL DETERMINATION.

Any judicial determination made pursuant to section 401 shall be binding for the taxable years involved on any State given notice thereof or appearing as a party thereto, notwithstanding any prior determinations of the courts or administrative bodies of that State completed after notice to that State. No statute of limitations shall bar the right of a State or a taxpayer to an amount of tax increased or decreased in accordance with such determination, provided action to recover such amount is instituted within one year after such determination has become final.

SEC. 403. CONFORMING AMENDMENT TO TITLE 28, UNITED STATES CODE.

Title 28, United States Code, is hereby amended by adding after section 1507 the following new section:

"SEC. 1508. JURISDICTION TO REVIEW CERTAIN DISPUTES INVOLVING STATE TAXATION OF INTERSTATE COMMERCE.

"The Court of Claims shall have jurisdiction to render judgment upon any petition for review under section 401 of the Interstate Taxation Act of 1979."

TITLE V—MISCELLANEOUS PROVISIONS

SEC. 501. PROHIBITION AGAINST OUT-OF-STATE AUDIT CHARGES.

No charge may be imposed by a State or political subdivision thereof to cover any part of the cost of conducting outside that State an audit for a tax to which this Act applies.

By Mr. MATHIAS:

S. 983. A bill to regulate and foster commerce among the States by providing a system for the taxation of interstate commerce; to the Committee on Finance.

INTERSTATE TAXATION ACT OF 1979

● Mr. MATHIAS. Mr. President, I am today introducing the Interstate Taxation Act of 1979.

In 1789, the Founding Fathers replaced the Articles of Confederation with our Constitution. In large measure, they did so because commerce and trade—so vital to the security and prosperity of every American—could not flourish in the confusion of multiple and often conflicting local laws.

Our Constitution was written as a compact between States willing to trade shortrun gains for long-term progress in an orderly federal system of free-flowing commerce.

Today that system is not functioning as efficiently as it should. A major obstacle to interstate commerce lies in the complex and often conflicting State and

local tax rules that confront firms in interstate commerce. These rules harm both business and our State and local governments—and, in the end, deprive all our citizens of the efficiency that leads to lower prices and the tax revenue that finances government services.

I have been deeply concerned with this problem since I served on the House Special Committee on State Taxation of Interstate Commerce. In 1964 we issued a report based on an extensive study of this problem. We found that sales and use taxes were levied by approximately 2,300 State and local units. That number has increased by 250 percent since the 1964 report. In addition, there are corporate income tax laws in all but five States of the Union.

Businesses now have such a complex set of rules to comply with that they often fail to pay tax liabilities simply because they are unaware of them. Some States have laws that are effectively useless because companies having ephemeral contacts with these States are not familiar with the particular idiosyncracies of these laws. There are no uniform accounting principles by which businesses can compute their liability if they do business in varying amounts in a number of different States. It has long been obvious that the burden of even attempting to comply with the multiplicity of State and local laws is particularly onerous for small business. My bill will put all businesses on notice that those States in which they operate to such an extent that they come within the Federal guidelines can impose and collect taxes on their sales and income.

Over the years of my service in both the House and Senate, I have introduced a series of bills which would address this problem. These bills have incorporated the ideas of representatives of State and local government and business groups. The bill I introduce today, like my earlier bills, will regularize the jurisdictional principles by which States impose sales, use, income and gross receipts taxes.

In the 90th and 91st Congresses the House passed, by overwhelming majorities, State taxation legislation similar in thrust to my bill. The Senate Finance Committee created a Subcommittee on Interstate Taxation in the 93d Congress to hold hearings and give serious consideration to the problem. Vice President MONDALE, then Senator MONDALE, who chaired the subcommittee, said that its purposes were to—

> examine the problems posed for interstate income businesses by the multifarious corporate income- and sales and use taxes imposed by the different states. . . . [F]urther House action now appears unlikely unless the Senate acts first and, in an effort to begin Senate action, the subcommittee is holding hearings.

Other business has kept the Finance Committee from taking action on the findings of these hearings.

The basic objectives of this bill are the same as legislation which I have introduced in the past, including S. 2080 in the 94th Congress and S. 2173 in the 95th. However, there are several major differences between this bill and it predecessors.

Many of these changes are the result of testimony before the Judiciary Committee in the 95th Congress. I was authorized by the chairman, Senator Eastland, to conduct hearings on S. 2173 in Biloxi, Miss.; Charleston, S.C.; Columbus, Ohio; and San Francisco, Calif.

The hearings went very well, and I think we have built a solid record that sets the scene for action this year in the Senate Finance Committee. Senator HARRY BYRD, chairman of the Finance Committee's Subcommittee on Taxation and Debt Management, assures me that hearings will be held in the near future. We had tentatively set in March 30, but I asked Senator BYRD to postpone the hearing until May, so that State tax authorities will have ample time to study my proposal. And, I hope to become convinced that it makes sense.

Action on interstate taxation in the 95th Congress was not limited to the Senate. The House Ways and Means Committee directed the General Accounting Office to study State and Federal approaches to the taxation of multistate and multinational corporations. Chairman ULLMAN listed several issues he wanted GAO to study, including:

Whether State apportionment formulae are rationally based in economic theory, are equitable, or are an administrative burden;

The feasibility of all States using the same apportionment methods;

The effect on the States of being required to use the arm's length method in taxing multinational corporations; and

Whether the Internal Revenue Service is having difficulties in administering section 482, which provides for the arm's length method, and, if so, whether the cause is poor management, a flawed conception, or both.

We all await the GAO report with great interest.

During the Senate debate on the United States-United Kingdom Tax Treaty, many House members spoke with me about the possibility of substituting my bill for article 9(4) of the treaty. They wanted a chance to address the issues raised by article 9(4), which would have barred unitary taxing States from including the income of British parent companies in their assessment of income tax on the in-state subsidiary. A legislative approach to the problem would have given them that chance. The treaty approach, however, left the House of Representatives out in the cold.

It may be too early to designate 1978 as a watershed year, but I think we can see certain patterns emerging. The American taxpayer has blown the whistle on Government waste and inefficiency and the mounting toll they take in taxes. In the name of efficiency and commonsense, the taxpayer wants something new.

As all of you know, businesses want something new, too. They want uniformity in interstate taxation to reduce their paperwork burden and to increase their efficiency. They want long-term certainty and predictability in tax liability. And they want to pay no more than their fair share of the tax burden so they can remain competitive.

State authorities, on the other hand, want business to pay its fair share of the tax burden, and they want to protect local business from unfair competition from out of State. And they want to keep their enforcement costs to a minimum.

These are legitimate concerns on both sides. To meet them, I have redrafted my bill, taking into account the testimony at the hearings. As an indication that the day of reckoning is at hand, I understand that both the State representatives and the business representatives are now considering other compromise bills. I haven't seen them yet, but I am pleased that there appears to be some movement away from the irreconcilable poles of only a few years ago and toward middle ground. I expect that the bill I introduce today will be only a starting point, a vehicle to start the debate. The bill that finally emerges from the legislative process will be one all parties can live with.

Others too are pressing for legislative solutions. Last summer, the Supreme Court, in Moorman Manufacturing against Bair, stated:

"[T]he prevention of duplicative taxation . . . would require national uniform rules for the division of income."

The Court then pointed out:

"While the freedom of the states to formulate the independent policy in this area may have to yield to an overriding national interest in uniformity, the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to the interests of all affected states. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income. It is to that body, and not this court, that the Constitution has committed such policy decisions."

In the wake of that decision, which gave the States carte blanche to adopt discriminatory tax formulae, Illinois is now considering an amendment to its tax code that would help the in-State manufacturers. The District of Columbia as well as Minnesota, is contemplating similar amendments. Obviously, the time has come to act before these protectionist efforts get out of hand.

Let me briefly outline the new bill. In the income tax title, changes are primarily technical. Basically, the bill still provides an optional three-factor formula for apportioning the income of interstate corporations. This three-factor approach, which considers sales, property, and payroll, would divide taxes fairly between the various jurisdictions. While a taxpayer could use the formula provided in the State law, the three-factor formula and other provisions of title III would determine the maximum tax liability that could be imposed. I should add to this three-factor test is already used in most of the States, so it would not revolutionize State tax collection.

I have revised last year's version to accommodate the two most common criticisms made at the field hearings. One change makes it clear that the taxpayer should not have the option of electing world-wide combination while the State would be prohibited from requiring such combination. The other change clears up some confusion in the treatment of foreign source income in section 358.

Unlike the income tax title, the sales and use title has undergone major revision in the direction of compromise.

The proposed changes will relieve small business of a lot of paperwork. They include an innovative "buyer certification plan" which would greatly reduce the burden on those businesses without a business location within the taxing

State. At the same time, the revision assures, to a large extent, the rights of the States to collect sales and use tax revenues. Large businesses, which generally have the resources to comply with existing law, are excluded from the buyer certification election under two provisions. First, they ordinarily have a business location within the taxing State and, second, buyer certification is permitted only for those firms that have less than $100,000 in taxable sales within the taxing State. That jurisdictional trigger is based on the previous year's sales.

The buyer certification procedure allows a purchaser to certify the rate and amount of local and State sales or use tax to the buyer. This certification could be included on the purchase order. Sellers would collect the certified amount and remit that directly to the State without accounting for destinations within the State. If a buyer refused to certify, the seller would collect the maximum combined State and local tax applicable in the State.

The U.S. Secretary of Commerce would be involved in three minor ways: First, the Secretary would prescribe a standard form; second, a return filed with the Secretary would suffice as a return filed with any State; and third, each State would certify to the Secretary the maximum combined State and local rate within that State.

In addition, persons with taxable sales of less than $20,000 in a State would be exempt from filing returns except to the extent that they had collected a tax from their buyer. Again, qualification for this exemption would be based on the previous year's sales.

Finally, the requirements for exemption certificates on exempt sales have been tightened up. The provision in the draft bill is essentially identical to the one found in S. 2080, which I introduced in the 94th Congress. Also, I have deleted the household goods exemption, which was often criticized by State authorities.

On the gross receipts side, I have added the phrase:

"Nothing herein shall affect the power of a state or political subdivision to impose a gross receipts tax on intra-state activities, including a tax levied on the extraction of oil, coal or minerals."

This addition should put to rest many of the fears expressed by West Virginia and the other gross receipts States.

I think this draft takes a significant step toward uniformity—which business needs—and full accountability—which the States rightfully demand. To the extent there is some tax and administrative relief, such relief is focused narrowly on the small firm trying to extend its sales beyond its home State.

Obviously, one of our big jobs is to allay the fears of State and local authorities and to help them see that they have a mutuality of interest with business on this issue.

I am convinced that if we work toward an efficient tax collection system, our industries will be at less of a disadvantage in the international market than they are now.

This is important. The United States no longer dominates the world marketplace completely. We have to compete with other economies whose efficiency is nearly legend. The examples that leap to mind, of course, are Germany and Japan.

Our competitors overseas are concerned with efficiency. They put great value on insuring that commerce flows freely—both domestically and internationally—without unnecessary and inefficient impediments. And an efficient economy includes efficient government and the efficient collection of taxes.

A tax system that creates headaches and uncertainties destroys efficiency.

Business, as we all know, must weigh a multitude of essentially unquantifiable and uncontrollable factors—supply, demand, weather, mood, competition—and it is the brilliant business executive who spots trends and makes sound decisions. In the face of all this necessary uncertainty, I find it ironic that taxation—a factor we have the power to control completely, a factor that could be simple, straightforward and predictable—is kept complex, fraught with uncertainty, and in a constant state of flux.

We must admit to ourselves that by tolerating such an irrational system, we cripple our businesses in the world of foreign trade. And we cost the American consumer a great deal of money.

Businesses in West Germany and Japan are not saddled with the additional expense of complying with unnecessarily complicated tax laws. Their executives and merchants do not waste valuable time and energy filling our forms and worry-

ing about noncompliance. They are free to think creatively about the things they should be thinking about; namely, making better products, providing better service, and making more money. The consumer—Japanese, German, or American for that matter—is the ultimate beneficiary.

Napoleon III took great pride in pulling out his pocket watch and telling foreign dignitaries that at that precise moment every 12-year-old French child was hearing a lecture, for example, on the role Louis XIV played in the War of the Spanish Succession. We have done well without that kind of national uniformity, but, in the field of taxation, diversity is expensive, and has no apparent offsetting virtues. It creates no useful tension; it simply creates headaches that ultimately raise costs for the consumer.

We cannot wait any longer for reform. We must act now. For too long, the debate has been bogged down in the technical language of the experts. We have passively adopted their terms of reference and conducted the debate at the wrong level. We must raise the level of the debate and talk frankly about the larger issues—about jobs, the national interest, and economic survival.

My point is simple—if rational people were to sit down to devise a rational tax system, they would not devise a system anything like ours. Japan and Germany had the advantage of starting out with clean slates after the war. I hope it will not take a similar cataclysm to show us the error of our ways.

We cannot afford antagonism between business and State governments. What we need, what we must have, and what this bill will help to bring about, is an era of cooperation between government and business that will give a major boost to the American economy.

This bill is a first step toward a more efficient and more equitable system of taxation. I am encouraged by the progress we have made in the 95th Congress, and I am convinced that finally, after 18 years, we will be able to bring this project to fruition in the 96th Congress.

PRESENT STATUS OF INTERSTATE TAXATION BILL

Senator MATHIAS. Before I close, let me bring you up to date on just where the interstate taxation bill stands.

The Judiciary Committee, which had joint jurisdiction with the Finance Committee, held hearings in Biloxi, Miss., Charleston, S.C., Columbus, Ohio, and San Francisco, Calif. This built a very solid record which sets the scene for some action in the Finance Committee this year.

Our distinguished colleague from Virginia, Senator Byrd, chairman of the Subcommittee on Taxation and Debt Management, has assured me that hearings will be held. In fact, he had tentatively set them for the latter part of March, but at my request he postponed them until July so that the State taxing authorities will have ample time to study the proposals and to react. And, I would hope to become convinced that what we are proposing makes some sense and to make sure that we had copies of the hearing records available despite the backlog at the Government Printing Office.

I take the time to recount this evidence of progress for this reason, which I believe is important to this committee. I have heard from a number of people in the United Kingdom that Parliament will ratify the United States-United Kingdom Treaty only if there is a perception in Westminster that we are, in fact, serious about making progress on the interstate taxation bill or some version of it.

In this regard, I have a statement from Mr. Grylls, whom I introduced earlier, who is a Member of Parliament. Indeed, he is a member of the majority party, which gives his statement a somewhat more authoritative ring than it might have otherwise. I would suggest, Mr. Chairman, that it might be appropriate if the statement which I received from Mr. Grylls might be made a part of the record.

Senator STONE. We would be happy to include it in the record. It will be very useful to our colleagues and we appreciate receiving it.

[The information referred to follows:]

PREPARED STATEMENT OF MICHAEL GRYLLS, M.P., REGARDING THE DOUBLE TAXATION RELIEF TREATY BETWEEN THE UNITED STATES AND THE UNITED KINGDOM

I have been a Member of the House of Commons since 1970. As I was involved in private business prior to my first election I have been vitally interested in the relation of government and industry, both nationally and internationally. I am a member of the Conservative Commonwealth Council, a Fellow of the Royal Institute of International Affairs, and have served as Vice-Chairman of the Conservative Industry Committee.

Thus, I followed the discussions in Parliament regarding this Treaty between the United States and the United Kingdom quite closely, with particular attention to the treatment in the Treaty of the use of the world-wide combined reporting systems in assessing the taxation of companies doing business in both countries, even elsewhere. When the House of Commons considered the Treaty on January 12, 1977, it was pointed out that there was no possibility of double taxation and under it barriers to international investment would be reduced, preserving and hopefully increasing the number of jobs in both countries. It also appeared that the consequences of the Treaty, especially regarding remittances, looked far more favorable to the United States and its Internal Revenue Service, than to the United Kingdom

Article 9(4) of the Treaty was considered to be an essential part. Its importance was due to the fact that it would put right the plainly wrong situation wherein certain states in the United States could impose taxes on companies not by virtue of their operation in a single state alone, but by the size of their operations throughout the world. With Article 9(4) the United States was saying to Great Britain, "We want your business and your jobs, not just your taxes." Without it, it is obvious the interest in taxes is paramount.

When we considered the Treaty we did so without the benefit of knowing how the United States Senate would treat the Treaty. That body subsequently removed Article 9(4). A third Protocol to that effect has resulted and is now before the United States Senate for ratification. Of course, if approved by the Senate, approval must also be obtained from Parliament.

There is substantial evidence that the absence of an Article 9(4) type prohibition in the Treaty will cause it to be subject to very close scrutiny and enlarged debate as we consider it in the House of Commons. The Confederation of British industry, which is the representative body of British industry, both public and private, has recently written to the Chancellor of the Exchequer, Sir Geoffrey Howe, suggesting that the Treaty should not be adopted in its present form. The Confederation pointed out to the Chancellor that the "combined reporting unitary system" of taxation leads to multiple taxation and in fact has been condemned by the Organisation for Economic Co-operation and Development of which both the United States and the United Kingdom are members. I understand that the United States Supreme Court has in a recent decision also condemned taxation by states upon instruments of foreign commerce when it results in double taxation or prevents the United States from speaking in one voice regarding such international activities.

The Chairman of the Bowater Corporation Limited, The Rt Hon Lord Erroll of Hale, in his statement contained in its 1978 Annual Report and Accounts, said that such taxation systems "if widely adopted, could cause groups of companies which operate internationally to suffer multiple taxation on their profits. This would clearly be both unjust and inimical to the proper flow of international investment."

A resolution has been placed before the International Chamber of Commerce which makes clear the need for one voice in matters on international taxation by political subdivisions and urges all possible measures be taken to ensure that the terms of an agreement or treaty dealing with taxation on income shall bind all authorities having jurisdiction within the boundaries of each contracting state.

Attached to this statement is a copy of an Early Day Motion which will be introduced in the House when it returns from recess on June 11, 1979. That motion reveals that prohibition of the use of the worldwide combined reporting systems

of taxation assessment is essential to any United States-United Kingdom relationship regarding multiple taxation. Personally, I have been amazed at the short-sighted view taken by the Third Protocol and have marvelled that my country (the largest foreign investor in the United States and heretofore I thought welcome in the United States), and the United States which together have the largest numbers of multinational corporations in the world, and thus the most to lose from setting such a precedent, would negotiate such an open ended, unjust and potentially damaging arrangement making available this practice of multiple taxation to other countries and their political subdivisions.

I have reviewed the hearings of the Senate Foreign Relations Committee regarding the Treaty and read the pages of the Congressional Record containing the debate concerning its ratification. I noticed an admission among those who expressed opposition to Article 9(4) that there was a problem caused by the unrestrained use of the worldwide combined reporting system and that the sensible way of solving the problem was one of legislation which would be considered by both Houses of Congress.

I am aware that legislation has been introduced in the United States Senate sections of which address this problem. From my understanding of the recent United States Supreme Court decision it appears that if the Treaty does not deal with this problem, and the United States Congress otherwise fails to address it, then aggrieved companies will certainly be in a position to resort to the United States courts for relief at great costs not only to companies, but the individual state governments as well.

British industry and Parliament shall be following with great interest the discussions of the Treaty by the Senate Foreign Relations Committee and the full Senate. Indications and assurance that the problems caused both the United States and the United Kingdom by the use of the worldwide combined reporting system are being rectified either in the Treaty or by legislation which will be passed by the United States Congress will be quite helpful in obtaining approval of any treaty submitted to Parliament for approval.

HOUSE OF COMMONS—LONDON SWIA OAA

EARLY DAY MOTION TO BE SUBMITTED TO THE HOUSE OF COMMONS ON JUNE 11, 1979

That this House is of the view that a vital feature of any relationship between the United States of America and the United Kingdom regarding relief from double taxation should be a clear understanding prohibiting the use of the worldwide combined reporting system in assessing the tax of corporations doing business in both countries, such as would have been accomplished by Article 9(4) of the original Double Taxation Relief Treaty between the United States and the United Kingdom; and this House urges Her Majesty's Government to ensure that arrangements be made to rectify a harmful international precedent and serious consequences for both British and United States companies with overseas interests.

Senator MATHIAS. I am glad that he is here today. If Mr. Grylls disagrees, he can object to my assertion that Parliament will not accept a treaty as it is now drafted unless there are assurances that a legislative resolution of this problem is imminent. I would observe that Mr. Grylls has not only not objected, but seems to be in agreement on that point.

RENEGOTIATION IF INTERSTATE TAX BILL FAILS PASSAGE

The Confederation of British Industry, which is the equivalent of the United States Chamber of Commerce, as you know, has recommended that the whole treaty be renegotiated if this legislation, the interstate tax bill, fails at passage in the U.S. Congress. So, these seem to be two questions that are very closely linked.

Now, the issue is a lot larger than just a single provision in a single treaty. The United States has to speak with one voice in foreign relations, and the Constitution requires that the Federal Government

provide that voice. I think no one is more aware of that obligation than members of this committee. If the President and the Congress cannot guarantee protection from double taxation to our trading partners abroad, then who can? With some justification, foreign nations might logically conclude that they must negotiate separate treaties with each of the 50 States of the Union if they are to protect their interests. Of course, the Constitution bars that recourse.

So, we are, in effect, telling these foreign governments that they have no way to protect themselves by the treaty process, which is a kind of catch-22 situation for them.

SUPREME COURT ROLE IN DECIDING UNITARY TAXATION PROBLEM

Another avenue of relief is available, but I think it is too speculative to provide comfort. The Supreme Court could rule that the unitary system of taxation violates the commerce clause of the Constitution. In my opinion, the Court is, in fact, moving in that direction, even while it protests all the way that it is up to the Congress and not to the Court to solve the problem and has constantly invited the Congress to act. I think we should not shirk that responsibility.

So I hope that the Foreign Relations Committee will join in this effort. I am sure the Finance Committee will give great weight to the views of this committee. I hope you will help me to press for action before the Finance Committee in July.

I am encouraged by the progress that we made in the last Congress. I am convinced we will be able to bring this project to fruition in the 96th Congress. I think we have to send a signal to our friends and allies, our trading partners, those people in whom the distinguished Senator from New York has taken such an active interest during his entire career. I think favorable action on section 303 of this bill would be a very clear signal that would be applauded all around the world.

Mr. Chairman, I leave my case at this point. I commend the statement that Marlow Cook is about to make. He has given the matter tremendous study, and out of his experience and wisdom I think further light will be shed on this subject.

Thank you, Mr. Chairman.

Senator STONE. Senator Mathias, we thank you.

Senator Javits.

SENATOR MATHIAS ROLE IN UNITED STATES-UNITED KINGDOM TRADE RELATIONSHIP

Senator JAVITS. Thank you, Mr. Chairman.

Senator Mathias, thank you very much. May I say that I think your efforts are contributing enormously to the trading relationship between the United Kingdom and the United States. I am very hopeful that we can work out this situation along these lines you described, however, the optimum order—that is, consideration of the bill, Senate consideration of the treaty, and the disposition of the treaty by the British Parliament—may not be followed. I am hopeful that we can move Senate consideration of the treaty along.

Senator MATHIAS. I think we are fortunate that Mr. Grylls is here and can speak authoritatively as to the mood in the Parliament. Perhaps members of the committee or counsel will have an opportunity

to talk with him while he is in Washington. I think that would be useful.

Senator JAVITS. Off the record.

[Discussion off the record.],

Senator JAVITS. Thank you, Mr. Chairman.

Senator STONE. Thank you.

Senator JAVITS. Gentlemen, please forgive me if I leave briefly. There is some floor business I have to attend to. I will return.

Senator STONE. Gentlemen, we have just been informed that we will have to close this hearing at 12 noon. I will, therefore, ask that we observe the 5-minute rule.

Senator Marlow Cook is our next witness. Senator, we are pleased to have you before our committee today.

STATEMENT OF HON. MARLOW W. COOK, A FORMER U.S. SENATOR FROM KENTUCKY, COOK & HENDERSON, WASHINGTON, D.C.

Senator COOK. Thank you, Mr. Chairman. I will run through my statement as fast as I can, Senator, in view of your time constraints.

SENATE RESERVATION TO ARTICLE 9(4)

As you know, my name is Marlow Cook. As members of the committee are well aware, the Senate gave advice and consent to ratification of the tax convention on June 27, 1978, with a reservation as to article 9(4). The Senate's reservation stipulates that article 9(4) shall not apply to any political subdivision or local authority of the United States. The third protocol, accordingly, modifies article 9(4) to conform to the reservation.

Therefore, Mr. Chairman, the Senate today has the opportunity to reflect on its own handiwork. Under the terms of the third protocol, the 50 States of this Union are not prohibited from devising various and sundry plans for the application of the worldwide combined reporting system of tax assessment to British multinational corporations. Most regrettably, some States may consider the Senate's reservation an open invitation to join California, Alaska, and Oregon in asserting jurisdiction, for income tax purposes, over the worldwide profits of multinationals under one formula or another.

As you will recall, Senator Russell Long has a very apt statement for that, Mr. Chairman. He says, "Don't tax you and don't tax me. Tax that other fellow behind the tree."

DEFINITION OF WORLDWIDE COMBINED REPORTING SYSTEM OF TAXATION

Unfortunately, the term, "worldwide combined reporting system of taxation," cannot be defined with any degree of precision under U.S. law. There may be as many diverse applications of that concept of taxation as there are taxing jurisdictions with the ambition to reach foreign source income. All such methods, however, do have one common element in that they tax "that other fellow behind that tree."

REGULATIONS SET FORTH BY FRANCHISE TAX BOARD OF CALIFORNIA

It may be useful, as an illustration, to describe briefly the effort of the Franchise Tax Board of California.

The franchise tax board has demanded from foreign corporations doing business in California, either through a branch or a subsidiary, information on worldwide sales, property holdings, and payroll. The taxing authorities of California now regard business as being unified if it meets the test of more than 50-percent common ownership only, notwithstanding the fact that it may be operating in many disparate enterprises in scores of different countries.

Using a worldwide combined reporting formula that California alone may consider equitable, the global profits of businesses are subject to California taxation after California sales, property holdings, and payrolls are compared to worldwide sales, property, and payrolls.

As anyone can plainly see, the motive of the California tax authorities is to reach foreign source income that the Secretary of the Treasury of the United States has determined, for Federal income tax purposes, properly should be allocated under section 482 of the Internal Revenue Code to foreign operations and not taxed by the United States.

BROADER TAX BASE BY POLITICAL SUBDIVISIONS THAN FEDERAL GOVERNMENT

Thus, the incomprehensible result of the California innovation: The political subdivisions of our country are claiming a broader tax base, for income tax purposes, than Congress has permitted the Federal Government under the Internal Revenue Code. The sum of the parts, inescapably under this scheme, is greater than the whole.

In plain terms, Mr. Chairman, the Senate's reservation to the United States-United Kingdom Tax Convention can superficially be interpreted as an invitation for each of the 50 States to establish unilaterally its own tax policy for overseas operations of foreign corporations doing business within its jurisdiction.

There are a number of factors which would distort income allocation if each State of the United States is allowed to have regard to worldwide profits of a foreign multinational. I have listed six in my statement, Mr. Chairman, and I hope they would be set forth in the record as a part of my statement so that they will be considered by the committee.

Senator STONE. Your full statement will be included in the record at the appropriate point.

Senator COOK. In summary, Mr. Chairman, no system of worldwide combined reporting taxation can be established by a State on worldwide operations of a foreign multinational without substantial risk of arbitrary and unreasonable taxation of profits not properly allocable to operations within that State.

Of course, the Senate did not intend such results in adopting the reservation to the United States-United Kingdom Tax Convention. Fortunately, the Congress has pending legislation which would resolve the problem.

IMMEDIATE CONGRESSIONAL CONSIDERATION OF S. 983

As introduced by Senator Mathias, S. 983 would establish the proper limits on the ability of a State to apply the combined or consolidated method of taxation to the operations of a foreign multinational corporation. Throughout debate on the treaty in June of 1978, Senators made reference to the need for such legislation. It is now imperative that Congress proceed to the immediate consideration of Senator Mathias' bill.

The enactment of legislation to limit properly the scope of State taxation of foreign source income is necessary, as a practical matter, to obtain timely ratification of the third protocol by Parliament, which was explained by Senator Mathias. Leaders of the current Government of the United Kingdom have expressed distress over the vague and indefinite authority of the several States of the United States to tax worldwide profits of British multinationals. And no wonder. If Parliament were carefully to evaluate the various options available to the respective States under the Senate's reservation and the third protocol, it would be literally years before an intelligent assessment of the States' inherent power to tax could be made.

Any report to the Senate by this distinguished committee on the third protocol, therefore, should contain clear language outlining the practical necessity of domestic legislation along the lines of Senator Mathias' bill.

Mr. Chairman, the enactment of legislation such as S. 983, insofar as application of State taxation to worldwide operations is concerned, is much more than a practical necessity; it is mandated by the U.S. Constitution.

In a landmark case decided April 30, 1979, the Supreme Court has ruled that a State of the United States may not tax the instrumentalities of foreign commerce if the tax, and I will quote: "Create a substantial risk of international multiple taxation, and prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'"

The Court concluded, and again I quote: "If a State tax contravenes either of these precepts"—either of these precepts—"it is unconstitutional under the commerce clause." This is *Japan Line, Ltd.* v. *County of Los Angeles.* I have the Slip opinion, Mr. Chairman, and would like to ask that it be included in my statement and be printed in the hearing record.

Senator STONE. It will be included.

[The information referred to follows:]

(Slip Opinion)

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Lumber Co.*, 200 U.S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

JAPAN LINE, LTD., ET AL. *v.* COUNTY OF LOS ANGELES ET AL.

APPEAL FROM THE SUPREME COURT OF CALIFORNIA

No. 77–1378. Argued January 8, 1979—Decided April 30, 1979

Appellant Japanese shipping companies' vessels carry cargo containers which, like the ships, are owned by appellants, are based, registered, and subjected to property tax in Japan, and are used exclusively in foreign commerce. A number of appellants' containers were temporarily present in appellee county and cities in California, and appellees levied property taxes on the containers. The California Supreme Court upheld the tax as applied.

Held:

1. This Court has appellate jurisdiction under 28 U. S. C. § 1257 (2), since the California Supreme Court sustained the tax, as applied, as against the contention that such application would violate the Commerce Clause and various treaties. Pp. 5–6.

2. It is unnecessary to decide the broad proposition whether mere use of international routes is enough, under the "home port doctrine," to render an instrumentality immune from tax in a nondomiciliary State. The question here is a more narrow one, namely, whether instrumentalities of commerce that are owned, based, and registered abroad, and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State. Pp. 6–9.

3. While under *Complete Auto Transit, Inc.* v. *Brady*, 430 U. S. 274, no impermissible burden on interstate commerce will be found if a state tax "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State," *id.*, at 279, a more elaborate inquiry is necessary when a State seeks to tax the instrumentalities of foreign, rather than of interstate, commerce. In addition to answering the nexus, apportionment, and nondiscrimination questions posed in *Complete Auto*, a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial

risk of international multiple taxation, and, second, whether the tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments." *Michelin Tire Corp.* v. *Wages,* 423 U. S. 276, 285. If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause. Pp. 9–17.

4. The California ad valorem property tax, as applied to appellants' shipping containers, is unconstitutional under the Commerce Clause, since it results in multiple taxation of the instrumentalities of foreign commerce, *Moorman Mfg. Co.* v. *Bair,* 437 U. S. 267, distinguished, and prevents this Nation from "speaking with one voice" in regulating foreign trade and thus is inconsistent with Congress' power to "regulate Commerce with foreign nations." Pp. 17–22.

20 Cal. 3d 180, 571 P. 2d 254, reversed.

BLACKMUN, J., delivered the opinion of the Court, in which BURGER, C. J., and BRENNAN, STEWART, WHITE, MARSHALL, POWELL, and STEVENS, JJ., joined. REHNQUIST, J., filed a dissenting statement.

SUPREME COURT OF THE UNITED STATES

No. 77–1378

Japan Line, Ltd., et al., Appellants, *v.* County of Los Angeles et al. } On Appeal from the Supreme Court of California.

[April 30, 1979]

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

This case presents the question whether a State, consistently with the Commerce Clause of the Constitution, may impose a nondiscriminatory ad valorem property tax on foreign-owned instrumentalities (cargo containers) of international commerce.

I

The facts were "stipulated on appeal," App. 29, and were found by the trial court, *id.*, at 33–36, as follows:

Appellants are six Japanese shipping companies; they are incorporated under the laws of Japan, and they have their principal places of business and commercial domiciles in that country. *Id.*, at 34. Appellants operate vessels used exclusively in foreign commerce; these vessels are registered in Japan and have their home ports there. *Ibid.* The vessels are specifically designed and constructed to accommodate large cargo shipping containers.[1] The containers, like the ships,

[1] "A container is a permanent reusable article of transport equipment . . . durably made of metal, and equipped with doors for easy access to the goods and for repeated use. It is designed to facilitate the handling, loading, stowage aboard ship, carriage, discharge from ship, movement, and transfer of large numbers of packages simultaneously by mechanical means to minimize the cost and risks of manually processing each package."

are owned by appellants, have their home ports in Japan, and are used exclusively for hire in the transportation of cargo in foreign commerce. *Id.*, at 35. Each container is in constant transit save for time spent undergoing repair or awaiting loading and unloading of cargo. All appellants' containers are subject to property tax in Japan and, in fact, are taxed there.

Appellees are political subdivisions of the State of California. Appellants' containers, in the course of their international journeys, pass through appellees' jurisdictions intermittently. Although none of appellants' containers stays permanently in California, some are there at any given time; a container's average stay in the State is less than three weeks. *Ibid.* The containers engage in no intrastate or interstate transportation of cargo except as continuations of international voyages. *Id.*, at 30. Any movements or periods of nonmovement of containers in appellees' jurisdictions are essential to, and inseparable from, the containers' efficient use as instrumentalities of foreign commerce. *Id.*, at 35–36.

Property present in California on March 1 (the "lien date" under California law) of any year is subject to ad valorem property tax. Cal. Rev. & Tax. Code Ann. §§ 117, 405, 2192 (West 1970 & Supp. 1978). A number of appellants' containers were physically present in appellees' jurisdictions on the lien dates in 1970, 1971, and 1972; this number was fairly representative of the containers' "average presence" during each year. App. 35. Appellees levied property taxes in excess of $550,000 on the assessed value of the containers

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Simon, The Law of Shipping Containers, 5 J. Maritime L. & Comm. 507, 513 (1974).

See Customs Convention on Containers, Art. I (b), May 18, 1956, [1969] 20 U. S. T. 301, 304, T. I. A. S. No. 6634. Although containers may be as small as 1 cubic meter (35.3 cubic feet), 49 CFR § 420.3 (c)(5) (1977), they are typically 8 feet high, 8 feet wide, and between 8 and 40 feet long. Simon, at 510.

present on March 1 of the three years in question. *Id.*, at 36. During the same period, similar containers owned or controlled by steamship companies domiciled in the United States, that appeared from time to time in Japan during the course of international commerce, were not subject to property taxation in Japan, and therefore were not, in fact, taxed in that country. *Id.*, at 35.

Appellants paid the taxes, so levied, under protest and sued for their refund in the Superior Court for the County of Los Angeles. That court awarded judgment in appellants' favor.[2] *Id.*, at 39–40. The court found that appellants' containers were instrumentalities of foreign commerce that had their home ports in Japan where they were taxed. The federal courts, however, in the trial court's view, had "consistently held that vessels which are instrumentalities of foreign commerce and engaged in foreign commerce can be taxed in their home port only." *Id.*, at 24. This rule, said the court, was necessary to avoid multiple taxation, *id.*, at 23; whereas apportionment of taxes can be used to prevent duplicative taxation in interstate commerce, apportionment is "not practical" when one of the taxing entities is a foreign sovereign. In such cases, "[t]here is no tribunal that can adjudicate [competing] rights unless it be the International Court and to invoke its services jurisdiction must be consented to by all parties." *Id.*, at 24. The application of appellants' taxes in derogation of the "home port doctrine," the court concluded, subjected international commerce to multiple taxation and thus was unconstitutional under the Commerce Clause. In so holding, the court followed *Scandinavian Airlines System, Inc.* v. *County of Los Angeles* (hereinafter *SAS*), 56 Cal. 2d 11, 363 P. 2d 25, cert. denied, 368 U. S. 899 (1961) (ruling that ad valorem property tax levied by California upon aircraft owned, based, and registered abroad and used exclusively

[2] The opinion of the Superior Court is not officially reported.

in international commerce, was unconstitutional under the Commerce Clause).

The Court of Appeal reversed. 132 Cal. Rptr. 531 (1976). The court appeared to conclude that *SAS* had been effectively overruled by *Sea-Land Service, Inc.* v. *County of Alameda*, 12 Cal. 3d 772, 528 P. 2d 56 (1974). In *Sea-Land*, the Supreme Court of California had criticized the home port doctrine and labeled it "anachronistic," and had upheld apportioned property taxation of containers owned by a domestic corporation and used in both intercoastal and foreign commerce. *Id.*, at 787, 528 P. 2d, at 66. The Court of Appeal rejected appellants' arguments that a different result was required here in view of their containers' foreign ownership and exclusively international use. The court likewise dismissed any argument as to multiple taxation. "[T]he possibility of international double taxation of instrumentalities of foreign commerce," it concluded, is "no reason to limit the local power to tax them upon a nondiscriminatory apportioned basis." 132 Cal. Rptr., at 533.[3]

[3] The Court of Appeal also rejected, 132 Cal. Rptr., at 534, appellants' argument that California's tax was prohibited by Art. XI, §§ 1 & 4, and by Art. XXII, § 2, of the Treaty of Friendship, Commerce and Navigation Between the United States of America and Japan, Apr. 2, 1953, [1953] 4 U. S. T. 2063, T. I. A. S. No. 2863 (providing that Japanese nationals residing in the U. S. may not be subjected to payment of taxes "more burdensome than those borne by" United States nationals, and according Japan "most favored nation" status). Appellants repeat this argument here, and we reject it. The provisions appellants cite interdict *discrimination* against Japanese nationals; there is no evidence that California has treated Japanese containers differently from domestic containers for purposes of applying its property tax.

The Court of Appeal likewise rejected, 132 Cal. Rptr., at 533, appellants' argument that California's tax constituted an indirect "duty of Tonnage" proscribed by U. S. Const., Art. I, § 10, cl. 3. Appellants repeat this argument here; in view of our disposition, we do not reach it. The Court of Appeal noted that appellants did not challenge California's tax on due process grounds. See 132 Cal. Rptr., at 532 n. 2. Although appellants proffer a due process challenge here, we need not reach it either.

The California Supreme Court granted a hearing of the case and it, too, reversed the judgment of the Superior Court, essentially adopting the opinion of the Court of Appeal. 20 Cal. 3d 180, 571 P. 2d 254 (1977). It concluded that "the threat of double taxation from foreign taxing authorities has no role in commerce clause considerations of multiple burdens, since burdens in international commerce are not attributable to discrimination by the taxing state and are matters for international agreement." *Id.*, at 185, 571 P. 2d, at 257. Deeming the containers' foreign ownership and use irrelevant for purposes of constitutional analysis, *id.*, at 186, 571 P. 2d, at 257–258, the court rejected appellants' Commerce Clause challenge and sustained the validity of the tax as applied.[4]

Appellants appealed. We postponed consideration of our jurisdiction to the hearing on the merits. 436 U. S. 955 (1978).

II

This Court has appellate jurisdiction to review a final judgment rendered by the highest court of a State in which a

[4] The California Supreme Court also rejected appellants' argument that California's tax constituted "Imposts or Duties" proscribed by U. S. Const., Art. I, § 10, cl. 2. 20 Cal. 3d, at 186–188, 571 P. 2d, at 258–259. Appellants reiterate this argument here; in view of our disposition, we do not consider it. In their petition for rehearing, appellants argued that the tax contravened Art. III, §§ 1 & 2 of the General Agreement on Tariffs and Trade (GATT), 61 Stat. A3, A18 (1947) (providing that "imported products" may not be subjected to heavier taxes, or to less favorable treatment, than like products of domestic origin). Petition for Rehearing 35–40. The court rejected this latter argument *sub silentio*. 20 Cal. 3d, at 190. Appellants repeat this argument here, and we deem it frivolous. Assuming *arguendo* that appellants' containers, as instrumentalities of commerce entering this country subject to re-exportation, could be labeled "imported products" within the meaning of GATT, the provisions on which appellants rely prohibit only *discriminatory* treatment. As noted above, *supra* n. 3, there is no evidence that California has treated Japanese containers differently from domestic containers for purposes of applying its property tax.

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decision could be had "where is drawn in question the validity of a statute of any state on the ground of its being repugnant to the Constitution, treaties or laws of the United States, and the decision is in favor of its validity." 28 U. S. C. § 1257 (2). In this case appellants drew in question the validity of California's ad valorem property tax, contending that the tax, as applied to their containers, was repugnant to the Commerce Clause and various treaties, and the California Supreme Court sustained the validity of the tax. Under these circumstances, this Court's appellate jurisdiction would seem manifest.

Appellees suggest that the California courts did not in reality uphold the tax statute against constitutional attack, but simply refused to extend to appellants a constitutional immunity from taxation. Motion to Dismiss or Affirm 2. Appellees' suggested recharacterization is unpersuasive. Appellants squarely challenged the constitutionality of the tax statute, as applied, and the California Supreme Court just as squarely sustained its validity, as applied. We have held consistently that a state statute is sustained within the meaning of § 1257 (2) when a state court holds it applicable to a particular set of facts as against the contention that such application is invalid on federal grounds. *E. g., Cohen* v. *California,* 403 U. S. 15, 17–18 (1971); *Warren Trading Post* v. *Arizona Tax Comm'n,* 308 U. S. 685, 686, and n. 1 (1965); *Bantam Books, Inc.* v. *Sullivan,* 372 U. S. 58, 61 n. 3 (1963); *Dahnke-Walker Milling Co.* v. *Bondurant,* 257 U. S. 282, 288–290 (1921). We conclude that we have appellate jurisdiction of this case.

III

A

The "home port doctrine" was first alluded to in *Hays* v. *Pacific Mail S. S. Co.,* 17 How. 596 (1854). In *Hays,* California sought to impose property taxes on ocean-going vessels intermittently touching its ports. The vessels' home port was New York City, where they were owned, registered, and

based; they engaged in intercoastal commerce by way of the Isthmus of Panama, and remained in California briefly to unload cargo and undergo repairs. This Court held that the ships had established no tax situs in California:

> "We are satisfied that the State of California had no jurisdiction over these vessels for the purpose of taxation; they were not, properly, abiding within its limits, so as to become incorporated with the other personal property of the State; they were there but temporarily, engaged in lawful trade and commerce, with their *situs* at the home port, where the vessels belonged, and where the owners were liable to be taxed for the capital invested, and where the taxes had been paid." *Id.*, at 599–600.

Because the vessels were properly taxable in their home port, this Court concluded, they could not be taxed in California at all.[5]

The "home port doctrine" enunciated in *Hays* was a corollary of the medieval maxim *mobilia sequuntur personam* ("movables follow the person," see Black's Law Dictionary 1154 (rev. 4th ed. 1968)) and resulted in personal property being taxable in full at the domicile of the owner. This theory of taxation, of course, has fallen into desuetude, and the "home port doctrine," as a rule for taxation of moving equipment, has yielded to a rule of fair apportionment among the States. This Court, accordingly, has held that various instrumentalities of commerce may be taxed, on a properly apportioned basis, by the nondomiciliary States through which they travel. *E. g., Pullman's Palace Car Co.* v. *Pennsylvania*, 141 U. S. 18 (1891); *Ott* v. *Mississippi Valley Barge Line Co.*, 336 U. S. 169 (1949); *Braniff Airways, Inc.* v. *Nebraska State Bd. of*

[5] The "home port doctrine" was reaffirmed, as to ocean-going vessels, in *Morgan* v. *Parham*, 16 Wall. 471, 476–477 (1872), and in *Southern Pac. Co.* v. *Kentucky*, 222 U. S. 63, 69 (1911). It was applied to vessels moving in inland waters in *St. Louis* v. *Ferry Co.*, 11 Wall. 423 (1870), and in *Ayer & Lord Tie Co.* v. *Kentucky*, 202 U. S. 409, 421–423 (1906).

Equalization, 347 U. S. 590 (1954). In discarding the "home port" theory for the theory of apportionment, however, the Court consistently has distinguished the case of ocean-going vessels. *E. g., Pullman's Palace*, 141 U. S., at 23–24 (approving apportioned tax on railroad rolling stock, but distinguishing vessels "engaged in interstate or foreign commerce upon the high seas"); *Ott*, 336 U. S., at 173–174 (approving apportioned tax on barges navigating inland waterways, but "not reach[ing] the question of taxability of ocean carriage"); *Braniff*, 347 U. S., at 600 (approving apportioned tax on domestic aircraft, but distinguishing vessels "used to plow the open seas"). Relying on these cases, appellants argue that the "home port doctrine," yet vital, continues to prescribe the proper rule for state taxation of ocean-going ships. Since containers are "functionally a part of the ship," *Leather's Best, Inc.* v. *S. S. Mormaclynx*, 451 F. 2d 800, 815 (CA2 1971), appellants conclude, the containers, like the ships, may be taxed only at their home ports in Japan, and thus are immune from tax in California.

Although appellants' argument, as will be seen below, has an inner logic, we decline to cast our analysis of the present case in this mold. The "home port doctrine" can claim no unequivocal constitutional source; in assessing the legitimacy of California's tax, the *Hays* Court did not rely on the Commerce Clause, nor could it, in 1854, have relied on the Due Process Clause of the Fourteenth Amendment. The basis of the "home port doctrine," rather, was common-law jurisdiction to tax.[6] Given its origins, the doctrine could be said to be "anachronistic"; given its underpinnings, it may indeed be said to have been "abandoned." *Northwest Airlines, Inc.* v. *Minnesota*, 322 U. S. 292, 320 (1944) (Stone, C. J., dissent-

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[6] See, *e. g.*, Note, 49 Cal. L. Rev. 968, 970–971 (1961); Note, State Taxation of International Air Transportation, 11 Stan. L. Rev. 518, 522, and n. 19 (1959); Page, Jurisdiction to Tax Tangible Movables, 1945 Wis. L. Rev. 125, 143–144.

ing). As a theoretical matter, then, to rehabilitate the "home port doctrine" as a tool of Commerce Clause analysis would be somewhat odd. More importantly, to hold in this case that the "home port doctrine" survives would be to prove too much. If an ocean-going vessel could indeed be taxed only at its home port, taxation by a nondomiciliary State logically would be barred, regardless of whether the vessel were domestically- or foreign-owned, and regardless of whether it were engaged in domestic or foreign commerce. In *Hays* itself, the vessel was owned in New York and was engaged in interstate commerce through international waters. There is no need in this case to decide currently the broad proposition whether mere use of international routes is enough, under the "home port doctrine," to render an instrumentality immune from tax in a nondomiciliary State. The question here is a much more narrow one, that is, whether instrumentalities of commerce that are owned, based, and registered abroad and that are used exclusively in international commerce, may be subjected to apportioned ad valorem property taxation by a State.[7]

B

The Constitution provides that "Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." Art. I, § 8, cl. 3. In construing Congress' power to "regulate Commerce . . . among the several States," the Court recently has affirmed that the Constitution confers no immunity from

[7] Accordingly, we do not reach questions as to the taxability of foreign-owned instrumentalities engaged in interstate commerce, or of domestically-owned instrumentalities engaged in foreign commerce. Cf. *Sea-Land Service, Inc.* v. *County of Alameda*, 12 Cal. 3d 772, 528 P. 2d 56 (1974) (domestically-owned containers used in intercoastal and foreign commerce held subject to apportioned property tax); *Flying Tiger Line, Inc.* v. *County of Los Angeles*, 51 Cal. 2d 314, 333 P. 323 (1958) (domestically-owned aircraft used in foreign commerce held subject to apportioned property tax).

state taxation, and that "interstate commerce must bear its fair share of the state tax burden." *Washington Revenue Dept.* v. *Association of Wash. Stevedoring Cos.*, 435 U. S. 734, 750 (1978). Instrumentalities of interstate commerce are no exception to this rule, and the Court regularly has sustained property taxes as applied to various forms of transportation equipment. See *Pullman's Palace*, *supra* (railroad rolling stock); *Ott*, *supra* (barges on inland waterways); *Braniff*, *supra* (domestic aircraft). Cf. *Central Greyhound Lines* v. *Mealey*, 334 U. S. 653, 663 (1948) (motor vehicles). If the state tax "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State," no impermissible burden on interstate commerce will be found. *Complete Auto Transit, Inc.* v. *Brady*, 430 U. S. 274, 279 (1977); *Washington Revenue Dept.*, 435 U. S., at 750.

Appellees contend that cargo shipping containers, like other vehicles of commercial transport, are subject to property taxation, and that the taxes imposed here meet *Complete Auto*'s four-fold requirements. The containers, they argue, have a "substantial nexus" with California because some of them are present in that State at all times; jurisdiction to tax is based on "the habitual employment of the property within the State," *Braniff*, 347 U. S., at 601, and appellants' containers habitually are so employed. The tax, moreover, is "fairly apportioned," since it is levied only on the containers' "average presence" in California.[8] The tax "does not discriminate,"

[8] By taxing property present on the "lien date," California roughly apportions its property tax for mobile goods like containers. For example, if each of appellants' containers is in California for three weeks a year, the number present on any arbitrarily selected date would be roughly 3/52 of the total entering the State that year. Taxing 3/52 of the containers at full value, however, is the same as taxing all the containers at 3/52 value. Thus, California effectively apportions its tax to reflect the

thirdly, since it falls evenhandedly on all personal property in the State; indeed, as an ad valorem tax of general application, it is of necessity nondiscriminatory. The tax, finally, is "fairly related to the services provided by" California, services that include not only police and fire protection, but the benefits of a trained work force and the advantages of a civilized society.

These observations are not without force. We may assume that, if the containers at issue here were instrumentalities of purely interstate commerce, *Complete Auto* would apply and be satisfied, and our Commerce Clause inquiry would be at an end. Appellants' containers, however, are instrumentalities of foreign commerce, both as a matter of fact [9] and as a matter of law.[10] The premise of appellees' argument is that the Commerce Clause analysis is identical, regardless of whether

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containers' "average presence," *i. e.*, the time each container spends in the State per year.

[9] As noted above, the trial court found that appellants' containers are "instrumentalities of foreign commerce" that are "used constantly and exclusively for the transportation of cargo for hire in foreign commerce." App. 35, 36.

[10] Appellants' containers entered the United States pursuant to the Customs Convention on Containers, see n. 1, *supra*, which grants containers "temporary admission free of import duties and import taxes and free of import prohibitions and restrictions," provided they are used solely in foreign commerce and are subject to re-exportation. 20 U. S. T., at 304. Similarly, 19 CFR § 10.41a (a)(3) (1978) designates containers "instruments of international traffic," with the result that they "may be released without entry or the payment of duty" under 19 U. S. C. § 1322 (a). See 19 CFR § 10.41a (a)(1) (1978). A bilateral tax convention between Japan and the United States associates containers with the vehicles that carry them, and provides that income "derived by a resident of a Contracting State . . . from the use, maintenance, and lease of containers and related equipment . . . in connection with the operation in international traffic of ships or aircraft . . . is exempt from tax in the other Contracting State." Convention Between the United States of America and Japan for the Avoidance of Double Taxation, Mar. 8, 1971, [1972] 23 U. S. T. 967, 1084–1085, T. I. A. S. No. 7365.

interstate or foreign commerce is involved. This premise, we have concluded, must be rejected. When construing Congress' power to "regulate Commerce with foreign Nations," a more extensive constitutional inquiry is required.

When a State seeks to tax the instrumentalities of foreign commerce, two additional considerations, beyond those articulated in *Complete Auto,* come into play. The first is the enhanced risk of multiple taxation. It is a commonplace of constitutional jurisprudence that multiple taxation may well be offensive to the Commerce Clause. *E. g., Evco* v. *Jones,* 409 U. S. 91, 94 (1972); *Central R. Co.* v. *Pennsylvania,* 370 U. S. 607, 612 (1962); *Standard Oil Co.* v. *Peck,* 342 U. S. 382, 384–385 (1952); *Ott,* 336 U. S., at 174; *J. D. Adams Mfg. Co.* v. *Storen,* 304 U. S. 307, 311 (1938). In order to prevent multiple taxation of interstate commerce, this Court has required that taxes be apportioned among taxing jurisdictions, so that no instrumentality of commerce is subjected to more than one tax on its full value. The corollary of the apportionment principle, of course, is that no jurisdiction may tax the instrumentality in full. "The rule which permits taxation by two or more states on an apportionment basis precludes taxation of all of the property by the state of the domicile. . . . Otherwise there would be multiple taxation of interstate operations." *Standard Oil Co.* v. *Peck,* 342 U. S., at 384–385; *Braniff,* 347 U. S., at 601. The basis for this Court's approval of apportioned property taxation, in other words, has been its ability to enforce full apportionment by all potential taxing bodies.

Yet neither this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value.[11] If a State should seek to tax the same instrumen-

[11] Ocean-going vessels, for example, are generally taxed only in their

tality on an apportioned basis, multiple taxation inevitably results. Hence, whereas the fact of apportionment in interstate commerce means that "multiple burdens logically cannot occur," *Washington Revenue Dept.*, 435 U. S., at 746–747, the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even though "fairly apportioned" to reflect an instrumentality's presence within the State, may subject foreign commerce " 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' " *Evco* v. *Jones*, 409 U. S., at 94, quoting *J. D. Adams Mfg. Co.*, 304 U. S., at 311.

Second, a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. Foreign commerce is preeminently a matter of national concern. "In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power." *Board of Trustees* v. *United States*, 289 U. S. 48, 59 (1933). Although the Constitution, Art. I, § 8, cl. 3, grants Congress power to regulate commerce "with foreign Nations" and "among the several States" in parallel phrases, there is evidence that the Founders intended the scope of the foreign commerce power to be the greater.[12] Cases of this Court, stressing the need

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nation of registry; this fact in part explains the phenomenon of "flags of convenience" (a term deemed derogatory in some quarters), whereby vessels are registered under the flags of countries that permit the operation of ships "at a nominal level of taxation." See B. Boczek, Flags of Convenience 5, 56–57 (1962). Aircraft engaged in international traffic, apparently, are likewise "subject to taxation on an unapportioned basis by their country of origin." Note, 11 Stan. L. Rev., at 519, and n. 11. See, *e. g.*, *SAS*, 56 Cal. 3d, at 17, and n. 3, 363 P. 2d, at 28, and n. 3.

[12] *E. g.*, The Federalist No. 42, pp. 279–283 (J. Cooke ed. 1961) (Madi-

for uniformity in treating with other nations, echo this distinction.[13] In approving state taxes on the instrumentalities of interstate commerce, the Court consistently has distinguished ocean-going traffic, *supra*, p. 8; these cases reflect an awareness that the taxation of foreign commerce may necessitate a uniform national rule. Indeed, in *Pullman's Palace*, *supra*, the Court wrote that the " 'vehicles of commerce by water being instruments of intercommunication with other nations, the regulation of them is assumed by the national

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son); 3 M. Farrand, The Records of the Federal Convention of 1787, at 478 (1911) (Madison). See Note, State Taxation of International Air Carriers, 57 Nw. U. L. Rev. 92, 101, and n. 42 (1962); Note, 11 Stan. L. Rev., see n. 6, *supra*, at 525–526, and n. 29; Abel, The Commerce Clause in the Constitutional Convention and in Contemporary Comment, 25 Minn. L. Rev. 432, 465–475 (1941) (concluding, after an exhaustive survey of contemporary materials: "Despite the formal parallelism of the grants, there is no tenable reason for believing that anywhere nearly so large a range of action was given over commerce 'among the several states' as over that 'with foreign nations.' " *Id.*, at 475).

[13] *E. g.*, *Buttfield* v. *Stranahan*, 192 U. S. 470, 492–493 (1904) ("exclusive and absolute" power of Congress over foreign commerce); *Bowman* v. *Chicago & N. R. Co.*, 125 U. S. 465, 482 (1888) ("It may be argued [that] the inference to be drawn from the absence of legislation by Congress on the subject excludes state legislation affecting commerce with foreign nations more strongly than that affecting commerce among the States. Laws which concern the exterior relations of the United States with other nations and governments are general in their nature, and should proceed exclusively from the legislative authority of the nation."); *Henderson* v. *Mayor of New York*, 92 U. S. 259, 273 (1875) (regulation "must of necessity be national in its character" when it affects "a subject which concerns our international relations, in regard to which foreign nations ought to be considered and their rights respected."); *Gibbons* v. *Ogden*, 9 Wheat. 1, 228–229 (1824) (Johnson, J., concurring). See also *Atlantic Cleaners & Dyers, Inc.* v. *United States*, 286 U. S. 427, 434 (1932). In *National League of Cities* v. *Usery*, 426 U. S. 833 (1976), the Court noted that Congress' power to regulate interstate commerce may be restricted by considerations of federalism and state sovereignty. It has never been suggested that Congress' power to regulate foreign commerce could be so limited.

legislature.'" 141 U. S., at 24, quoting *Railroad Co.* v. *Maryland*, 21 Wall. 456, 470 (1874). Finally, in discussing the Import-Export Clause, this Court, in *Michelin Tire Corp.* v. *Wages*, 423 U. S. 276, 285 (1976), spoke of the Framers' overriding concern that "the Federal Government must speak with one voice when regulating commercial relations with foreign governments." The need for federal uniformity is no less paramount in ascertaining the negative implications of Congress' power to "regulate Commerce with foreign Nations" under the Commerce Clause.[14]

A state tax on instrumentalities of foreign commerce may frustrate the achievement of federal uniformity in several ways. If the State imposes an apportioned tax, international

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[14] The policies animating the Import-Export Clause and the Commerce Clause are much the same. In *Michelin*, the Court noted that the Import-Export Clause met three main concerns: "[T]he Federal Government must speak with one voice when regulating commercial relations with foreign governments . . . ; import revenues were to be the major source of revenue of the Federal Government and should not be diverted to the States; and harmony among the States might be disturbed unless seaboard States . . . were prohibited from levying taxes on [goods in transit]." 423 U. S., at 285–286 (footnotes omitted). Abel, see n. 12, *supra*, observed that the Commerce Clause was directed to similar concerns. See 25 Minn. L. Rev., at 448, and n. 67, 452, and n. 81, 456–457, and n. 110 (need to deal in unified manner with foreign nations); *id.*, at 446–451 (need to preserve federal revenue); *id.*, at 448–449, and nn. 69–70, 470–471, 472–473 (need to prevent disharmony among States on account of import duties). In *Washington Revenue Dept.*, *supra*, we noted that the third *Michelin* factor—preserving harmony among the States—mandated the same inquiry as to the effect of a state tax as the interstate Commerce Clause. See 435 U. S., at 754–755. In this case, similarly, the first *Michelin* factor—the need to speak with one voice when regulating commercial relations with foreign governments—mandates the same inquiry as to the effect of a state tax as the foreign Commerce Clause. In *Washington Revenue Dept.*, the Court, holding that the state tax at issue did not prevent "speaking with one voice," noted: "No foreign business or vessel is taxed." 435 U. S., at 754.

disputes over reconciling apportionment formulae may arise.[15] If a novel state tax creates an asymmetry in the international tax structure, foreign nations disadvantaged by the levy may retaliate against American-owned instrumentalities present in their jurisdictions. Such retaliation of necessity would be directed at American transportation equipment in general, not just that of the taxing State, so that the Nation as a whole would suffer.[16] If other States followed the taxing State's example, various instrumentalities of commerce could be subjected to varying degrees of multiple taxation, a result that would plainly prevent this Nation from "speaking with one voice" in regulating foreign commerce.

For these reasons, we believe that an inquiry more elaborate than that mandated by *Complete Auto* is necessary when a State seeks to tax the instrumentalities of foreign, rather than of interstate, commerce. In addition to answering the nexus, apportionment, and nondiscrimination questions posed in *Complete Auto*, a court must also inquire, first, whether the tax, notwithstanding apportionment, creates a substantial risk of international multiple taxation, and, second, whether the

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[15] See Developments in the Law—Federal Limitations on State Taxation of Interstate Business, 75 Harv. L. Rev. 953, 986 (1962) (noting the difficulty of allocating "international bridge time" for aircraft engaged in international commerce, with consequent risk of multiple taxation from overlapping apportionment formulae, and concluding that apportioned state taxation of foreign-owned aircraft should be forbidden).

[16] Cf. *Chy Lung* v. *Freeman*, 92 U. S. 275, 279 (1875) (invalidating California's bond requirement for Chinese immigrants):

"[I]f this plaintiff and her twenty companions had been subjects of the Queen of Great Britain, can any one doubt that this matter would have been the subject of international inquiry, if not of a direct claim for redress? Upon whom would such a claim be made? Not upon the State of California; for, by our Constitution, she can hold no exterior relations with other nations. It would be made upon the government of the United States. If that government should get into a difficulty which would lead to war, or to suspension of intercourse, would California alone suffer, or all the Union?"

tax prevents the Federal Government from "speaking with one voice when regulating commercial relations with foreign governments." If a state tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause.

C

Analysis of California's tax under these principles dictates that the tax, as applied to appellants' containers, is impermissible. Assuming, *arguendo,* that the tax passes muster under *Complete Auto,* it cannot withstand scrutiny under either of the additional tests that a tax on foreign commerce must satisfy.

First, California's tax results in multiple taxation of the instrumentalities of foreign commerce. By stipulation, appellants' containers are owned, based, and registered in Japan; they are used exclusively in international commerce; and they remain outside Japan only so long as needed to complete their international missions. Under these circumstances, Japan has the right and the power to tax the containers in full. California's tax, however, creates more than the *risk* of multiple taxation; it produces multiple taxation in fact. Appellants' containers not only "are subject to property tax . . . in Japan," App. 32, but, as the trial court found, they "are, in fact, taxed in Japan." *Id.,* at 35. Thus, if appellees' levies were sustained, appellants "would be paying a double tax." *Id.,* at 23.[17]

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[17] The stipulation of facts, App. 32, like the trial court's finding, *id.,* at 35, states that "[a]ll containers of [appellants] are subject to property tax and are, in fact, taxed in Japan." The record does not further elaborate on the nature of Japan's property tax. Appellants have uniformly insisted, Brief 9, Tr. of Oral Arg. 3, that Japan's property tax is unapportioned, *i. e.,* that it is imposed on the containers' full value, and we so understand the trial court's finding. Although appellees do not seriously challenge this understanding, Brief 10–11, and n. 2, *amicus curiae* Multistate Tax Commission suggests that the record is inadequate to establish double taxation in fact: Japan, *amicus* says, may offer "credits . . . for taxes paid elsewhere." Brief 8. *Amicus* provides no evidence to support this theory.

Second, California's tax prevents this Nation from "speaking with one voice" in regulating foreign trade. The desirability of uniform treatment of containers used exclusively in foreign commerce is evidenced by the Customs Convention on Containers, which the United States and Japan have signed. See n. 10, *supra*. Under this Convention, containers temporarily imported are admitted free of "all duties and taxes whatsoever chargeable by reason of importation." 20 U. S. T., at 304. The Convention reflects a national policy to remove impediments to the use of containers as "instruments of international traffic." 19 U. S. C. § 1322 (a). California's tax, however, will frustrate attainment of federal uniformity. It is stipulated that American-owned containers are not taxed in Japan. App. 35. California's tax thus creates an asymmetry in international maritime taxation operating to Japan's disadvantage. The risk of retaliation by Japan, under these circumstances, is acute, and such retaliation of necessity would be felt by the Nation as a whole.[18] If other States follow California's exam-

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Both the Solicitor General, Brief for United States as *Amicus Curiae* 19 n. 9, and the Department of State, *id.*, at 17a, assure us that Japan taxes appellants' containers at their "full value," and we accept this interpretation of the trial court's factual finding.

Because California's tax in this case creates multiple taxation in fact, we have no occasion here to decide under what circumstances the mere *risk* of multiple taxation would invalidate a state tax, or whether this risk would be evaluated differently in foreign, as opposed to interstate, commerce. Compare *Moorman Mfg. Co.* v. *Bair*, 437 U. S. 267, 276–277 (1978), and *Washington Revenue Dept.*, 435 U. S., at 746, with, *e. g.*, *Central R. Co.*, 370 U. S., at 615; *Ott*, 336 U. S., at 175; and *Northwest Airlines*, 322 U. S., at 326 (Stone, C. J., dissenting).

[18] Retaliation by some nations could be automatic. West Germany's wealth tax statute, for example, provides an exemption for foreign-owned instrumentalities of commerce, but only if the owner's country grants a reciprocal exemption for German-owned instrumentalities. Vermögensteuergesetz (VStG) § 2, ¶ 3, reprinted in I Bundesgesetzblatt (BGBl) 949 (Apr. 23, 1974). The European Economic Community (EEC), when apprised of California's tax on foreign-owned containers, apparently deter-

ple (Oregon already has done so),[19] foreign-owned containers will be subjected to various degrees of multiple taxation, depending on which American ports they enter. This result, obviously, would make "speaking with one voice" impossible. California, by its unilateral act, cannot be permitted to place these impediments before this Nation's conduct of its foreign relations and its foreign trade.

Because California's ad valorem tax, as applied to appellants' containers, results in multiple taxation of the instrumentalities of foreign commerce, and because it prevents the Federal Government from "speaking with one voice" in international trade, the tax is inconsistent with Congress' power to "regulate Commerce with foreign Nations." We hold the tax, as applied, unconstitutional under the Commerce Clause.

D

Appellees proffer several objections to this holding. They contend, first, that any multiple taxation in this case is attributable, not to California, but to Japan. California, they say, is just trying to take its share; it should not be foreclosed by Japan's election to tax the containers in full. California's tax, however, must be evaluated in the realistic framework of the custom of nations. Japan has the right and the power to tax appellants' containers at their full value; nothing could prevent it from doing so. Appellees' argument may have force in the interstate commerce context. Cf. *Moorman Mfg. Co.* v. *Bair,* 437 U. S. 267, 277, and n. 12 (1978). In interstate commerce, if the domiciliary State is "to blame" for exacting an excessive tax, this Court is able to insist upon rationalization of the apportionment. As noted above, however, this Court is powerless to correct malapportionment of taxes imposed from abroad in foreign commerce.

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mined to consider "suitable counter-measures." Press Release, 521st Council Meeting—Transport (Luxembourg, June 12, 1978), p. 21.

[19] Ore. Op. Atty. Gen. No. 7709 (Jan. 31, 1979) (citing decision below).

Appellees contend, secondly, that any multiple taxation created by California's tax can be cured by congressional action or by international agreement. We find no merit in this contention. The premise of appellees' argument is that a State is free to impose demonstrable burdens on commerce, so long as Congress has not pre-empted the field by affirmative regulation. But it long has been "accepted constitutional doctrine that the commerce clause, without the aid of Congressional legislation . . . affords some protection from state legislation inimical to the national commerce, and that in such cases, where Congress has not acted, this Court, and not the state legislature, is under the commerce clause the final arbiter of the competing demands of state and national interests." *Southern Pacific Co.* v. *Arizona,* 325 U. S. 761, 769 (1945). Accord, *Hughes* v. *Oklahoma,* — U. S. —, and n. 2 (1979); *Boston Stock Exchange* v. *State Tax Comm'n,* 429 U. S. 318, 328 (1977). Appellees' argument, moreover, defeats, rather than supports, the cause it aims to promote. For to say that California has created a problem susceptible only of congressional—indeed, only of international—solution is to concede that the taxation of foreign-owned containers is an area where a uniform federal rule is essential. California may not tell this Nation or Japan how to run their foreign policies.

Third, appellees argue that, even if California's tax results in multiple taxation, that fact, after *Moorman,* is insufficient to condemn a state tax under the Commerce Clause. In *Moorman,* the Court refused to invalidate Iowa's single-factor income tax apportionment formula, even though it posed a credible threat of overlapping taxation because of the use of three-factor formulae by other States. See also the several opinions in *Moorman* in dissent. 437 U. S., at 281, 282, and 283. That case, however, is quite different from this one. In *Moorman,* the existence of multiple taxation, on the record then before the Court, was "speculative," *id.,* at 276; on the record of the present case, multiple taxation is a fact. In *Moorman,* the problem arose, not from lack of apportionment,

but from mathematical imprecision in apportionment formulae. Yet, this Court consistently had held that the Commerce Clause "does not call for mathematical exactness nor for the rigid application of a particular formula; only if the resulting valuation is palpably excessive will it be set aside." *Northwest Airlines* v. *Minnesota,* 322 U. S., at 325 (Stone, C. J., dissenting). Accord, *Moorman,* 437 U. S., at 274 (citing cases). See Hellerstein, State Taxation Under the Commerce Clause: An Historical Perspective, 29 Vand. L. Rev. 335, 347 (1976). This case, by contrast, involves no mere mathematical imprecision in apportionment; it involves a situation where true apportionment does not exist and cannot be policed by this Court at all. *Moorman,* finally, concerned interstate commerce. This case concerns foreign commerce. Even a slight overlapping of tax—a problem that might be deemed *de minimis* in a domestic context—assumes importance when sensitive matters of foreign relations and national sovereignty are concerned.[20]

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[20] Appellees' reliance on *Bob-Lo Excursion Co.* v. *Michigan,* 333 U. S. 28 (1948), is also misplaced. In that case, the appellant, a Michigan corporation, transported passengers from Detroit to an amusement park on an island in the Province of Ontario; the appellant refused to accept Negro passengers and was prosecuted under a Michigan civil rights statute. In sustaining the statute's application against Commerce Clause attack, the Court emphasized that the appellant conducted "foreign commerce" in name only. The sole business on the island was the amusement park, and it catered solely to American patrons. There were "no established means of access from the Canadian shore to the island," *id.,* at 36, and the island was "economically and socially . . . an amusement adjunct of the city of Detroit." *Id.,* at 35. The "highly closed and localized manner" in which the business was run insulated it "from all commercial or social intercourse and traffic with the people of another country usually characteristic of foreign commerce." *Id.,* at 36. The Court noted that the possibility of conflicting Canadian regulation was "so remote that it [was] hardly more than conceivable," *id.,* at 37, and concluded that, on the facts of the case, it was "difficult to imagine what national interest or policy, whether of securing uniformity in regulating commerce affecting relations with foreign nations or otherwise, could reasonably be found to be adversely

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Finally, appellees present policy arguments. If California cannot tax appellants' containers, they complain, the State will lose revenue, even though the containers plainly have a nexus with California; the State will go uncompensated for the services it undeniably renders the containers; and, by exempting appellants' containers from tax, the State in effect will be forced to discriminate against domestic, in favor of foreign, commerce. These arguments are not without weight, and, to the extent appellees cannot recoup the value of their services through user fees, they may indeed be disadvantaged by our decision today. These arguments, however, are directed to the wrong forum. "Whatever subjects of this [the commercial] power are in their nature national, or admit only of one uniform system, or plan of regulation, may justly be said to be of such a nature as to require exclusive legislation by Congress." *Cooley* v. *Board of Wardens*, 12 How. 299, 319 (1851). The problems to which appellees refer are problems that admit only of a federal remedy. They do not admit of a unilateral solution by a State.

The judgment of the Supreme Court of California is reversed.

It is so ordered.

Substantially for the reasons set forth by Justice Manuel in his opinion for the unanimous Supreme Court of California, MR. JUSTICE REHNQUIST is of the opinion that the judgment of that court should be affirmed.

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affected by applying Michigan's statute to these facts or to outweigh her interest in doing so." *Id.*, at 40.

Bob-Lo is consistent with both the analysis and the result in the present case. Whereas in *Bob-Lo* the risk that foreign commerce would be burdened by inconsistent international regulation was "remote," the risk that foreign commerce will be burdened by international multiple taxation here has been realized in fact. And whereas the Michigan statute posed no threat at all to the Federal Government's ability to "speak with one voice" in regulating foreign trade, the impairment of federal uniformity worked by California's statute is substantial.

STATE TAXES CREATE SUBSTANTIAL RISK OF MULTIPLE TAXATION

Senator Cook. It is indisputable that such State taxes create "a substantial risk of international multiple taxation." Indeed, international multiple taxation is the inevitable result, if not the fundamental purpose, of the unitary tax system when applied to international operations by a State. That a taxing State considers foreign taxes or income malapportioned or unfair is constitutionally irrelevant, according to the Supreme Court. Because neither the taxing State of this Union nor the Congress has the power to amend a foreign nation's domestic tax laws, it is necessary that the United States "speak with one voice when regulating commercial relations with foreign governments." Only Congress has the power under the Constitution to regulate commerce with foreign nations. Therefore, the standard for taxing international operations, whatever it may be, must be established by Congress. Of course, Congress has already established the standard in section 482 of the Internal Revenue Code. Now it remains for Congress to enforce that standard through enactment of those applicable provisions of Senator Mathias' bill.

More recently, Mr. Chairman, the Supreme Court has agreed to hear the case which came up from appeal from the Vermont Supreme Court. This is a decision against Mobil Oil Corp., whether it is constitutional for a State to tax dividends from foreign subsidiaries and investments received by corporations that are not in any way based in that State. Obviously, if Congress does not establish a proper one voice in taxing international operations, it appears that the Supreme Court may.

It would be foolhardy for Congress to endure decades of litigation as the endless variations and permutations of the worldwide combined reporting method of taxation by the several States are considered in the courts. Delay in dealing with this issue, as a nation, only invites retaliation by other countries who may follow the example, for instance, of California, in taxing the worldwide operations of those U.S. multinationals who do business within their jurisdictions.

The United States, with the most multinationals, has the most to lose if this innovation becomes customary under international law and practice.

Therefore, Mr. Chairman, we urge the Congress to deal decisively with the problem, as I have outlined it in this statement. I would hope that action by the Senate on the Mathias bill would take place in the immediate future.

Thank you.

[Senator Cook's prepared statement follows:]

PREPARED STATEMENT OF HON. MARLOW W. COOK, ESQ.

THE THIRD PROTOCOL FURTHER AMENDING THE TAX CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND

Mr. Chairman, Members of the Committee, I thank you for this opportunity to comment on the Third Protocol further amending the Tax Convention between the United States and the United Kingdom, signed at London on March 15, 1979, and transmitted by the President for Senate advice and consent to ratification on April 12, 1979.

My name is Marlow W. Cook, with the law firm of Cook & Henderson in Washington, D.C. These comments are submitted in behalf of Brown & Williamson Industries, Inc., a Kentucky-based subsidiary of BAT Industries, Limited. Our statement is limited to a single issue: The power of the several States of the United States to apply the worldwide combined reporting system of tax assessment to British multinational companies.

As members of this committee are well aware, the Senate gave advice and consent to ratification to the Tax Convention on June 27, 1978, with a reservation as to Article 9(4). That provision would have restricted the power of the several States to apply the "unitary method" or worldwide combined reporting system of taxation. The Senate's reservation stipulates that Article 9(4) shall not apply to any political subdivision or local authority of the United States. The Third Protocol, accordingly, modifies Article 9(4) to conform to the reservation.

Therefore, Mr. Chairman, the Senate today has the opportunity to reflect on its own handiwork. Under the terms of the Third Protocol, the fifty States of this Union are not prohibited from devising various and sundry plans for the application of the worldwide combined reporting system of tax assessment to British multinational corporations. Most regrettably, some States may consider the Senate's reservation an open invitation to join California, Alaska, and Oregon in asserting jurisdiction, for income tax purposes, over the worldwide profits of multinationals under one formula or another.

As Senator Russell Long has observed so often, to the delight of so many audiences, the best political strategy has to be:

"Don't tax you. Don't tax me. Tax that other fellow behind that tree."

Unfortunately, the term, "worldwide combined reporting system of taxation," cannot be defined with any degree of precision under United States law. There may be as many diverse applications of that concept of taxation as there are taxing jurisdictions with the ambition to reach foreign-source income. All such methods, however, do have one common element: They tax "that other fellow behind that tree."

It may be useful, as an illustration, to describe briefly the effort of the Franchise Tax Board of the State of California, acting in its discretion under California law, to tax foreign-source income using the worldwide combined reporting system.

The Franchise Tax Board has demanded from foreign corporations doing business in California, either through a branch or a subsidiary, information on worldwide sales, property holdings and payroll. The taxing authorities of California now regard business as being unified if it meets the test of more than 50 percent common ownership only, nothwithstanding the fact that it may be operating in many disparate enterprises in scores of different countries.

Using a worldwide combined reporting formula that California alone may consider equitable, the global profits of businesses are subject to California taxation after California sales, property holdings and payrolls are compared to worldwide sales, property, and payrolls.

As anyone can plainly see, the motive of the California tax authorities is to reach foreign-source income that the Secretary of the Treasury has determined, for Federal income tax purposes, properly should be allocated under section 482 of the Internal Revenue Code to foreign operations and not taxed by the United States.

Thus, the incomprehensible result of the California innovation: the political subdivisions of our country are claiming a broader tax base, for income tax purposes, than Congress has permitted the Federal Government under the code. The sum of the parts, inescapably under this scheme, is greater than the whole.

In plain terms, Mr. Chairman, the Senate's reservation to the United States-United Kingdom Tax Convention, can superficially be interpreted as an invitation for each of the fifty States to establish unilaterally its own tax policy for overseas operations of foreign corporations doing business within its jurisdiction.

There are a number of factors which would distort income allocation if each State of the United States is allowed to have regard to worldwide profits of a foreign multinational. The following summary is only illustrative of such distortions, and cannot be considered exhaustive:

First, sales values are determined by a number of factors which have no conceivable reference to U.S. experience. For example, in many under-developed countries and in some more advanced countries, sales taxes form a much higher percentage of total sales value than do those in this country.

Second, payroll costs will vary significantly between countries depending upon the relative prosperity of the countries involved.

Third, property values in under-developed countries are far lower than in the more advanced countries.

Fourth, currency exchange rate fluctuations can have a marked effect on profits.

Fifth, profits earned in some developing countries and in some nonmarket, or communist countries, may be substantial but not available to the organization outside those countries by reason of exchange control regulations.

Sixth, minority shareholdings and local law often have an effect on profit distribution, particularly in under-developed countries where governments have appropriated substantial minority interests.

In summary, Mr. Chairman, no system of worldwide combined reporting taxation can be established by a State on worldwide operations of a foreign multinational without substantial risk of arbitrary and unreasonable taxation of profits not properly allocable to operations within that State.

Of course the Senate did not intend such results in adopting the reservation to the United States-United Kingdom Tax Convention. Fortunately, the Congress has pending legislation which would resolve the problem.

As introduced by Senator Mathias, S. 983 would establish the proper limits on the ability of a State to apply the combined or consolidated method of taxation to the operations of a foreign multinational corporation. Throughout debate on the United States-United Kingdom Tax Convention in June of 1978, Senators made reference to the need for such legislation. It is now imperative that Congress proceed to the immediate consideration of Senator Mathias' bill.

The enactment of legislation to limit properly the scope of State taxation of foreign-source income is necessary, as a practical matter, to obtain timely ratification of the Third Protocol by Parliament. Leaders of the current government of the United Kingdom have expressed distress over the vague and indefinite authority of the several States of the United States to tax worldwide profits of British multinationals. And no wonder, if Parliament were carefully to evaluate the various options available to the States, under the Senate's reservation and the Third Protocol, it would be literally years before an intelligent assessment of the States' inherent power to tax could be made.

Any report to the Senate by this distinguished committee on the Third Protocol, therefore, should contain clear language outlining the practical necessity of domestic legislation along the lines of Senator Mathias' bill.

Mr. Chairman, the enactment of legislation such as S. 983, insofar as application of State taxation to worldwide operations is concerned, is much more than a practical necessity : it is mandated by the United States Constitution.

In a landmark case decided April 30, 1979, the U.S. Supreme Court has ruled that a State of the United States may not tax the instrumentalities of foreign commerce if the tax ". . . creates a substantial risk of international multiple taxation, and . . . prevents the Federal Government from 'speaking with one voice when regulating commercial relations with foreign governments.'"

The Court concluded, "If a State tax contravenes either of these precepts, it is unconstitutional under the Commerce Clause." *Japan Line, Ltd.* v. *County of Los Angeles*, No. 77–1378, decided April 30, 1979, Slip Opinion 16–17.

Although I will not take the time of his Committee to discuss in detail the holding of the Court in this case, I request that the text of the Court's opinion be printed in the record of these hearings following my testimony. Our analysis is that the worldwide combined reporting method of taxation, as applied by California, and probably Oregon and Alaska, is unconstitutional when applied to the worldwide operations of foreign corporations.

It is indisputable that such State taxes create ". . . a substantial risk of international multiple taxation . . . ." Indeed, international multiple taxation is the inevitable result, if not the fundamental purpose, of the unitary tax system when applied to international operations by a State. That a taxing State considers foreign taxes or income malapportioned or unfair, is constitutionally irrelevant, according to the Supreme Court. Because neither the taxing State of this Union nor the Congress has the power to amend a foreign nation's domestic tax laws, it is necessary that the United States ". . . . speak with one voice when regulating commercial relations with foreign governments." Only Congress has the power, under the Constitution, to "regulate Commerce with Foreign Nations." Therefore, the standard for taxing international operations, whatever it may be, must be established by Congress. Of course, Congress has already established the standard in section 482 of the Internal Revenue Code. Now it remains for Congress to enforce that standard through enactment of those provisions of Senator Mathias' bill that apply.

More recently the Supreme Court has agreed to decide in an appeal from a Vermont decision against Mobil Oil Corporation whether it's constitutional for a State to tax dividends from foreign subsidiaries and investments received by corporations that aren't based in the State. Obviously if Congress does not establish a proper one voice in taxing international operations it appears the Supreme Court will.

It would be foolhardy for Congress to endure decades of litigation as the endless variations and permutations of the worldwide combined reporting method of taxation by the several States are considered in the courts. Delay in dealing with this issue, as a Nation, only invites retaliation by other countries who may follow the example of California in taxing the worldwide operations of those U.S. multinationals who do business within their jurisdictions.

The United States, with the most multinationals, has the most to lose if the California innovation becomes customary under international law and practice.

Therefore, Mr. Chairman, we urge the Congress to deal decisively with the problem, as I have outlined it in this statement, at the earliest opportunity. Before Parliament is forced to deal with the uncertainty created by the Senate's reservation and this third Protocol, Congress must enact the necessary Federal legislation to ensure fair treatment of British multinationals by this country.

Thank you.

Senator STONE. Senator, what you are asking for, then, is report language?

Senator COOK. Absolutely.

Senator STONE. Thank you very much for your statement and for your brevity, too.

Senator COOK. Thank you. I did try.

Senator Stone. Our next witness is Mr. David H. Brockway, international tax counsel for the Joint Committee on Taxation.

STATEMENT OF DAVID H. BROCKWAY, INTERNATIONAL TAX COUNSEL, JOINT COMMITTEE ON TAXATION, ACCOMPANIED BY HOWARD M. WEINMAN, LEGISLATION ATTORNEY, AND THOMAS B. JOYCE, ACCOUNTANT, JOINT COMMITTEE ON TAXATION

Mr. BROCKWAY. Thank you, Mr. Chairman.

I am accompanied this morning by Howard Weinman and Tom Joyce of our staff, who also work on international tax matters and who have worked on these treaties.

Given the fact that we are now operating on the 5-minute rule, I will try to keep my comments very brief. In your opening statement, you did summarize the treaties, so I will not try to go over them now.

CONTROVERSY OF DRILLING CONTRACTOR ITEM

Let me make some general comments on the treaties and summarize the one issue that is presented in the treaties, the drilling contractor item.

We have analyzed the treaties thoroughly. As in the past, we have prepared pamphlets on all the treaties, and these are in your briefing booklets. The treaties do not contain any provisions that the Senate or the committee has objected to in the past. The treaties contain no provisions of any significance that are not substantially similar to provisions in other treaties, other than the one issue that is of controversy this morning.

In our preparation of the treaties, we had conversations with a number of experts in the area of international taxation and with groups affected by the treaties. There appears to be a general con-

sensus that the treaties are sound, that they are favorable to the United States, and that it would be appropriate for them to be approved by the committee and the Senate.

The one controversial issue involves the drilling contractors operating in the United Kingdom sector of the North Sea. This is in the protocol to the United Kingdom treaty, which was considered by the committee last year and approved by the Senate with a reservation.

The approval of this protocol is necessary before the treaty will go into effect. The British have indicated that they will not ratify the treaty unless certain modifications are made as concessions for the Senate's reservation regarding the State taxation issue. The one principal concession which they requested was the provision dealing with the contractors. They wanted the right to be able to tax U.S. drillers operating in the North Sea.

Senator STONE. After 30 days, I believe.

Mr. BROCKWAY. Yes; after 30 days. As a practical matter, I believe in order for the companies to be able to move their rigs into the area for drilling, either they or affiliates will be there for a 30-day period. So this will mean, basically, assuming that Great Britain adopts a tax—and I think it is likely that it will because it has asked for this reservation—that these companies will be subject to the tax.

TAXATION OF BRITISH RIGS OFF GULF COAST

The provision is reciprocal. It also means that we can tax the——

Senator STONE. The British rigs off Florida in the gulf coast?

Mr. BROCKWAY. Yes; exactly, in the gulf coast.

Senator STONE. Are there any?

Mr. BROCKWAY. I don't know whether Britain has any there. In 1969, the code was amended in order to make sure that we could tax foreign companies operating off our Continental Shelf. This was to protect them from those foreign companies that do operate there which may not be paying tax at the same level as the U.S. companies.

I understand from the affected industry that we have much greater activities overseas in foreign countries than they have here. But nevertheless, the provision is reciprocal. I think there are some taxpayers who are concerned about the other direction.

For the U.S. companies operating in the United Kingdom sector of the North Sea, the provision will permit the British to tax this income. The companies will be entitled to a foreign tax credit on their tax, but there is at least some possibility that some of the companies will not be able to get full use of the foreign tax credits because of our overall tax credit limitations. As a result, it is probable that at least some of them will have an aggregate tax increase—combined United States and British.

I think their objection—and I think it is accurate—is that they are the ones that would bear the brunt of a concession in order to get the treaty ratified. I think the argument in opposition is that it is not inappropriate for Great Britain to desire to tax this group. It is not an inappropriate provision in the treaty because the companies do have significant operations in the United Kingdom. It is just a question of what one can secure in negotiations. Treasury obviously concluded that this was a worthwhile concession in order to get the overall agreement and this is an issue the committee has to decide.

SENATE RESERVATION WILL PREVENT BRITISH RATIFICATION

I think it is fair to say that if the committee does recommend a reservation on this issue and the Senate does make a reservation, the British will not ratify the treaty, or are very unlikely to ratify the treaty without either further concessions from the United States, which may deny benefits that other taxpayers are presently getting, or, especially in light of the past history of this treaty and the 4 or 5 years it has been going on, they may just walk away entirely from the treaty.

So, you are presented with a situation that some taxpayers will pay some probable tax increase. But the offsetting risk is that quite a number of U.S. taxpayers will lose a great deal of benefits. Our estimates are that if the treaty is ratified this year, the present treaty will result in United Kingdom tax refunds to U.S. taxpayers of approximately $500 million for the retroactive period, and about $100 million a year thereafter.

This is what is at risk on this treaty and the protocol. This is not to say that the dollar amounts are the issue on which this matter should be decided. I think the fairness of this provision has to be decided on its own merits. But the committee also has to realize that there are a number of other taxpayers who would be affected by a reservation and the fairness of the loss of their treaty benefits must also be taken into account.

PROTOCOL ALLOWS PETROLEUM REVENUE TAX CREDITABLE TO BRITISH

Senator JAVITS [presiding]. I gather you have already made it clear, Mr. Brockway, that the new protocol will allow this petroleum revenue tax to be creditable only on British oil income, and not on OPEC oil income.

Mr. BROCKWAY. Exactly.

When the United Kingdom treaty was on the floor last Congress, Senator Kennedy raised a proposed reservation that would have had that effect. Treasury discussed this with the British and they indicated that they had no problem with such a provision. They gave assurances that they would negotiate along these lines. This is contained in this protocol.

OPERATORS SUBJECT TO BRITISH TAX PAST 30 DAYS

Senator JAVITS. I noticed that if the operators drill for more than 30 days in any year, they are subject to British tax. I gather that the Treasury is quite adamant against renegotiating that provision. Is that correct? Do you know, or will Mr. Lubick have to respond to that?

Mr. BROCKWAY. That is my understanding, but Mr. Lubick will be better able to tell you for certain.

Senator JAVITS. What is your opinion on the matter of this 30-day period? Is that arbitrarily too short?

Mr. BROCKWAY. I think that under our statutory law, we would tax without regard to any time period. We would tax if they were here for a year or for only one day. The British might decide to do that themselves. It would be a decision as to what the British would ask and what kind of agreement one could get regarding the period. I think the net effect of this protocol is that if these companies go into the United Kingdom sector and undertake any activities, they would come under this provision. So it might just as well have been one day.

Senator JAVITS. So, then, the 30 days really is not unreasonable. As you say, under our laws, there is no provision relating to a minimum time period at all.

Mr. BROCKWAY. There is no time limit under the statute. Under a model treaty, we would give up to 2 years. That is our negotiating position. It is just a matter of working out what both sides want and seeing who is affected.

[Mr. Brockway's prepared statement follows:]

PREPARED STATEMENT OF DAVID H. BROCKWAY, INTERNATIONAL TAX COUNSEL, HOWARD M. WEINMAN, LEGISLATION ATTORNEY, AND THOMAS B. JOYCE, ACCOUNTANT STAFF OF THE JOINT COMMITTEE ON TAXATION

It is our pleasure to appear before you to provide staff assistance on the four tax treaties and two protocols which are currently under consideration by your Committee. As in the past, our staff has prepared separate pamphlets on each of the treaties and protocols before you; these pamphlets give an article-by-article description of each treaty or protocol and generally indicate those provisions which differ significantly from those normally found in U.S. tax treaties. The introductions to each of these pamphlets highlight the provisions of the proposed treaties which present significant policy issues. In addition, we have, together with the staff of the Foreign Relations Committee, prepared a brief pamphlet summarizing the tax treaty process, the various tax treaties before the Committee today and those which are likely to be before the Committee within the next year.

These proposed treaties and protocols are, for the most part, noncontroversial. The one issue of particular controversy deals with the treatment of U.S. independent drilling contractors operating in the U.K. sector of the North Sea, and it arises in connection with the proposed protocol to the pending income tax treaty with the United Kingdom. The International Association of Drilling Contractors has requested that the Senate reserve on this provision. This issue is discussed below in connection with the proposed U.K. protocol, and it is discussed in more detail in the article-by-article analysis contained in the staff pamphlet on the protocol (pp. 9-12).

Proposed Third Protocol to Pending Income Tax Treaty with the United Kingdom

Importance of Ratification

The protocol to the pending tax treaty deals with issues which arose during the previous consideration of the treaty by the Senate and with other matters raised during discussion of those issues between the United States and the United Kingdom. Ratification of the proposed protocol is important because the pending income tax treaty with the United Kingdom, which the committee and the Senate approved last year (with a reservation

which is confirmed in the protocol), will not go into effect until and unless the protocol is ratified. Ratification of the pending treaty is very important to a large number of U.S. taxpayers. Among the very significant benefits provided to U.S. taxpayers under the pending treaty are the refunds of the U.K. Advance Corporation Tax to U.S. investors in U.K. corporations. The net payments by the United Kingdom to U.S. investors under these provisions are estimated at $465 million for 1973-1979, the period of retroactivity, and approximately $90 million a year thereafter.

Moreover, prompt action on the proposed protocol is important for at least two reasons in addition to the desire of both countries and affected taxpayers to have the new treaty in place as soon as possible. First, the protocol faces some opposition in the U.K. Parliament and significant delay in ratification of the protocol may endanger the changes for ratification of the pending treaty by the United Kingdom. The second cause of some time pressure for the Senate to act on this protocol relates to the retroactive aspects of the pending treaty. While there are no particular deadlines by which the treaty and protocol must go into effect without causing substantial additional disruption and confusion, the longer the delay the greater the problems that will arise. For example, the refunds of the U.K Advance Corporation Tax which the British agree under the treaty to pay to U.S. shareholders of U.K. corporations are payable for dividends paid since 1973 to U.S. portfolio investors and since 1975 to U.S. direct investors. Besides the difficulties in arranging for refunds on dividends paid several years ago, the uncertainty as to whether the treaty will be ratified causes U.S. parent companies problems in deciding on the most advantageous dividend policy from an aggregate U.S./U.K. tax standpoint. Similarly, administrative difficulties will also be presented to the IRS and affected U.K. taxpayers in connection with retroactive refunds under the treaty of U.S. withholding tax paid by U.K. direct investors in U.S. companies with respect to dividends paid since 1975 (the pending treaty lowers the rate to 5 percent from the 15-percent rate in the existing treaty) and refunds of the U.S. insurance excise tax on premiums paid since 1975 by U.S. insureds to British insurers (exempted under the pending treaty).

Provisions of the protocol

The three most significant issues dealt with by the protocol relate to the use by states of the unitary method of taxation, creditability of the British Petroleum Revenue Tax, and taxation of U.S. drilling contractors in the North Sea.

State taxation/unitary method (Article 9(4)).--The Senate approved the treaty subject to a reservation proposed by Sen. Church which deleted the state taxation provision (Article 9(4)). That article would have prohibited in the case of British multinationals the use by state taxing authorities of the world-wide combination/unitary method of apportionment to determine the income attributable to sources within, and thus taxable by, the state. That method is employed by several western states (particularly California).

The protocol follows the Senate's reservation and deletes the provision from the treaty insofar as it would have applied to the states. This is the result Sen. Church advocated. The limitation still applies to the Federal Government, but since the Federal income tax laws use the arm's-length method rather than the prohibited unitary method of apportionment, this is of no present practical consequence.

PRT.--The protocol places a per-country limit on the PRT provision of the pending treaty. The PRT provision requires the United States to grant a foreign tax credit for the U.K. Petroleum Revenue Tax paid by the U.S. oil companies. The protocol modifies the proposed treaty so that it only requires the United States to allow the credit for the PRT against the U.S. taxes imposed on U.K. source oil income of the companies. Treasury and the United Kingdom agreed to make this modification after Sen. Kennedy raised the matter during the Senate's consideration of the treaty last year. The objection to the treaty as originally drafted was that the oil companies could credit the PRT against their oil income from OPEC countries. The change made by the protocol satisfies Sen. Kennedy's concerns.

Offshore activities.--As a concession to the British for the U.S. refusal to accept the state taxation provision contained in Article 9(4) of the proposed treaty, the proposed protocol adds a new provision intended to deal primarily with the activities of certain U.S. independent drilling contractors and service and supply companies who operate on a temporary basis in the U.K. sector of the North Sea. Although the matter is not completely clear, these U.S. companies are of the opinion that under the proposed treaty (and also the existing treaty) they could not be taxed by the United Kingdom. This proposed protocol amends the proposed treaty to make it clear that the United Kingdom would not be prevented from taxing the activities of these companies under its domestic laws.

While this provision was added to the protocol at the request of the British, the provisions are reciprocal. That is, the protocol also makes it clear that British activities on the U.S. continental shelf may be taxed by the United States. The Internal Revenue Code was amended in 1969 so that foreign companies operating on the U.S. continental shelf would be fully subject to U.S. tax on the same basis as U.S. companies operating on the shelf (sec. 638).

The U.S. Association of Independent Drilling Contractors objects to these new provisions of the protocol. They argue that it is inappropriate for one industry to be singled out and, as a concession to the British, be denied a treaty benefit they have traditionally enjoyed. In addition, the contractors argue that it may be a precedent for other treaties.

The extent, if any, to which the imposition of British tax on the U.S. drilling contractors would increase their aggregate worldwide (i.e., combined U.S. and U.K.) tax liability is not clear. These U.S. contractors would generally be eligible for a U.S. foreign tax credit for any British taxes they might pay. With no other changes, a full U.S. foreign tax credit would mean that their aggregate worldwide tax payments would not be increased at all by the imposition of the British tax because for each dollar of British tax paid, there would be a corresponding dollar reduction in their U.S. tax. In other words, the U.S. Treasury, not the U.S. contractors, would bear the cost of the concession in that situation. However, a contractor would not get the benefit from the foreign tax credit to the extent that it is continuously in an excess foreign tax credit position.

However, even if the drilling contractors are able to get a full dollar-for-dollar reduction of their U.S. tax as the result of the foreign tax credit, they might lose the benefits of U.S. investment tax credits they are presently claiming because the foreign tax credit for the British taxes would reduce the U.S. tax against which they are presently claiming the investment tax credit. (The investment tax credit is limited to 60 percent, rising to 90 percent by 1982, of the taxpayer's U.S. tax liability after reduction by the foreign tax credit.) They would not, of course, be able to use their resulting excess U.S. investment tax credit against their British tax liability.

For example, if in 1982 a drilling contractor was not taxable in the United Kingdom and was subject to U.S. taxes (before investment tax credits) of $200, its maximum allowable U.S. investment tax credit would be $180 (90 percent of $200). If, however, it had that amount of credits, its net U.S. taxes would be $20. If it paid U.K. taxes of $100 and those U.K. taxes were fully creditable against its U.S. taxes, its U.S. tax liability (before investment tax credit) would be $100 and its maximum allowable investment tax credit would be $90. Its net U.S. tax would be reduced to $10, but its total taxes paid to both the United States and the United Kingdom would be increased to $110. Even though U.K.

taxes are fully creditable, the taxpayer's overall liability is increased by $90 because of the decrease in the investment tax credit limitation. This extra liability is paid entirely to the United Kingdom, and an additional $10 is shifted from the U.S. to the U.K. Treasury.

In making its decision as to whether it should recommend to the Senate that the reservation recommended by the independent drilling companies be adopted, it is important for the Committee to take into account the possible British reaction. There is the possibility that the British, faced with such a reservation, would refuse to accept the treaty and protocol unless the treaty were renegotiated to provide them with other concessions. These would involve further reductions in the U.S. taxes imposed on the U.S. activities of U.K. residents or the denial of benefits provided under the proposed treaty to other U.S. taxpayers. One likely candidate here would be the ACT refunds which the U.K. Treasury is obligated to make under the proposed treaty to U.S. direct investors in U.K. subsidiaries. Another possibility--one that is at least as likely in my opinion--is that the British would simply refuse to ratify the treaty, costing indirect investors as well as direct investors the British ACT refunds. The potential benefits which these U.S. taxpayers could possibly lose if the reservation is adopted far exceed the benefits that the affected independent drilling companies stand to lose if the reservation is not. This does not, of course, necessarily dictate the Committee's decision--the fairness of the protocol provision must be considered as well and it must be considered on its own merits. Nevertheless, the Committee must also consider the fairness to these other U.S. taxpayers whose treaty benefits might be lost if a reservation were adopted.

Social Security Taxes

The Treasury technical explanation and the Foreign Relations Committee report mistakenly state that the pending treaty applies to social security taxes of the two countries. The pending treaty does not, however, apply to these taxes. This is confirmed in a recent exchange of correspondence between the tax authorities of the two countries.

Protocol to Existing Income Tax Treaty with France

The proposed protocol to the income tax treaty between the United States and France was signed on November 24, 1978. A clarifying Exchange of Notes was signed on the same day. The protocol would amend the current U.S.-France income tax treaty, which entered into force on July 11, 1968. (The treaty was previously amended by another protocol which entered into force on January 21, 1972.)

The primary reason for negotiation of the protocol was a change in French domestic law which, effective January 1, 1979, for the first time subjected U.S. citizens resident in France to French tax on their worldwide income, including income from the United States. Prior to that time, these individuals were taxed by France on only their French-source income. This change could have resulted in significant double taxation of these individuals by France and the United States. The proposed protocol alleviates the impact of the new French law, essentially by dividing the tax revenue from U.S.-source income of these individuals between the U.S. and French Treasuries. In general, France agrees not to tax these individuals on some of their U.S.-source business income, and to give a credit for some of the U.S. tax on their U.S.-source investment income. The United States in turn agrees to treat some of this income as from French sources, which would make French taxes on the income eligible for the U.S. foreign tax credit against their U.S. tax liability. Special rules are prescribed for taxing the income of partners of partnerships with income from U.S. sources and retirees whose pensions are attributable to U.S. sources.

In the course of their negotiations concerning the double taxation issue, the U.S. and French representatives also agreed on a number of other changes to the existing treaty. Some of these changes deal with specific problems which have arisen in the administration of the treaty, while others generally modernize the treaty, bringing it into closer conformity with the current U.S. model income tax treaty. These changes are: (1) The United States generally agrees to exempt French insurers from the U.S. excise tax on foreign insurance of U.S. risks; (2) the wording of the geographical scope of the treaty is clarified so that the treaty expressly covers income from natural resources on each country's continental shelf; (3) the provisions governing shipping and air transport are revised to bring them into closer conformity with the U.S. model income tax treaty; (4) interest paid to banks is exempted from the 10-percent withholding tax allowed under the existing treaty; (5) social security payments made by either country to a U.S. citizen are exempted from tax by the other country; and (6) the "saving clause" of the treaty, which generally allows the United States to tax its own citizens and residents without regard to the treaty, is clarified so that it expressly applies to certain former U.S. citizens who expatriated to avoid U.S. tax.

Estate and Gift Tax Treaties with the United Kingdom and France

The proposed estate and gift tax treaties with the United Kingdom and France are the first negotiated by the United States since the comprehensive revision of U.S. estate and gift taxes as part of the Tax Reform Act of 1976. The new treaties are similar in concept to the last estate tax treaty negotiated by the United States, the treaty with The Netherlands, which entered into force in 1971. However, the new treaties take into account the recent revisions in U.S. law.

Both treaties are intended to avoid double taxation by the United States and the other treaty partner of estates and gifts. The treaties generally are intended only to benefit taxpayers. They impose no new taxes. However, under the "saving clause" in each treaty, they do not prevent U.S. taxation of its citizens domiciled abroad, after allowance of a foreign tax credit.

Estate and Gift Tax Treaty with the United Kingdom

The proposed treaty was signed by the United States and the United Kingdom on October 19, 1978. The portion of the proposed treaty dealing with estate taxation is intended to replace the existing estate tax treaty between the United States and the United Kingdom, which has been in force since July 25, 1946. There is no existing gift tax treaty between the two countries.

General principles

The intent of the proposed estate and gift tax treaty between the United States and the United Kingdom is to alleviate double taxation on the estates and gifts of citizens and domiciliaries of both countries by modifying the jurisdictional rules of estate and gift taxation with respect to these individuals. The treaty modifies these rules in two ways.

First each country has primary tax jurisdiction over the estates and gifts of its domiciliaries. However, real property and business assets which are located in the other country ("situs country") are generally subject to primary tax jurisdiction in the situs country. The treaty still allows taxation on the basis of citizenship, as provided by U.S. domestic law. If a decedent who was a U.S. citizen was domiciled in the United Kingdom and all his property was located there, the United States will allow a credit for the U.K. estate tax but, if the U.S. estate tax exceeds that amount, the United States will still collect the difference.

The second modification is that in situations where both countries under their own domestic law consider an individual to be a domiciliary, the individual will be treated as having only one country of domicile for purposes of the taxes covered by the treaty. The treaty sets forth several criteria to determine which country is the country of domicile.

Division of primary taxing jurisdiction

Both countries impose estate and gift taxes on the worldwide assets of their domiciliaries and on the property of nondomiciliaries located within their borders. Double taxation usually occurs in situations where a decedent was either domiciled in both countries or was domiciled in one country and owned property located in another country.

Since each country has its own definition of what constitutes domicile in that country, it is possible that the definition of domicile in the two countries could overlap and a person could thus be considered a domiciliary of both countries. As such, his estate would be subject to worldwide taxation by both countries.

When the decedent is considered domiciled in only one country but owned property in the other country at the time of his death, that property is subject to tax in the situs country regardless of the decedent's domicile. Thus, the country of domicile will tax the property, since it is included in the world-wide assets of the estate, and the situs country will tax the property because it was located within its boundaries at the time of the decedent's death.

In both of these situations, unless one of the two countries gives up its right to tax the property or allows a credit for the estate taxes paid to the other country, the estate will be subject to double taxation. A similar situation exists for gifts.

The proposed treaty will alleviate double taxation on gifts and estates of U.S. citizens and domiciliaries and U.K. domiciliaries by permitting each asset held by an estate or each gift to be subject to primary tax jurisdiction in only one of the two countries. This is accomplished in the treaty by allowing both countries to impose their tax but requiring one of the countries to allow a credit against its tax for the taxes paid to the other country. In most situations, the treaty allows the country of domicile to assert primary tax jurisdiction. However, the situs country is given a priority of taxation in the case of real property and business property (i.e., assets of a permanent establishment or a fixed base) which are located in that country.

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Determination of domicile

General.--The treaty provides that the domicile of an individual will be determined separately under the laws of each country. If only one of the two countries treats the individual as a domiciliary under its domestic laws, then that is the country of domicile for purposes of the treaty. However, if both countries treat the individual as a domiciliary under their domestic laws, then the treaty sets forth an extensive set of rules to determine the individual's domicile for purposes of establishing primary tax jurisdiction under the treaty. The approach used in this set of rules is to recognize that where an individual domiciled in both countries is a national of one of the two countries and has been resident for only a limited period of time in the other country, his ties with the country of residence are not sufficient to justify the assertion of primary tax jurisdiction by that country. However, where an individual has been domiciled in both countries for a substantial period of time, the country with which he has his closest ties (such as the place of his permanent home) has the greater claim to domicile and, thus, primary tax jurisdiction will generally be allowed to that country.

U.S. wives of U.K. domiciliaries.--Following the negotiation of the treaty, certain American women who are resident in the United Kingdom and who are married to U.K. nationals expressed concern about their treatment under the proposed treaty. Their concern related to a problem which arose and was resolved in connection with the pending income tax treaty. Under U.K. law prior to 1974, women of other nationalities who resided in the United Kingdom were conclusively presumed to be U.K. domiciliaries--and subject to tax on their non-U.K. assets--if they were married to U.K. nationals domiciled in the United Kingdom. In contrast, where the man was the foreign national resident in the United Kingdom and married to a resident U.K. national, domicile depended on all the surrounding facts and circumstances. U.K. law was amended in 1974 to eliminate their discriminatory treatment of foreign women who married U.K. nationals after 1974 by applying the facts and circumstances test in that situation also. The statutory change did not, however, apply to marriages occurring prior to 1974.

The second protocol to the income tax treaty resolved this problem for income tax purposes by applying the new non-discriminatory rules to U.S. women who married U.K. nationals before 1974. A similar resolution was not made in connection with the proposed estate and gift tax treaty for two reasons. First, in most cases

the American women who are affected by this change would be U.K. domiciliaries under the facts and circumstances test in any event, and therefore this change would not, as a practical matter, change their tax treatment. Second, in contrast with the pending income tax treaty, it is not always the case that treatment as a U.K. domiciliary is disadvantageous for U.S. wives of U.K. domiciliaries. The United Kingdom allows an unlimited marital deduction for transfers between spouses if both are U.K. domiciliaries. If one spouse is not a U.K. domiciliary, however, U.K. law only provides a limited marital exemption. Thus, if a wife leaves property to, or inherits property from, her U.K. domiciliary husband the transfer would be totally exempt from U.K. estate tax if she were treated as a U.K. domiciliary. However, because U.K. estate taxes are higher than U.S. estate taxes, she would pay more tax as a U.K. domiciliary on her property (not already subject to U.K. situs taxation) which she transfers to anyone but her husband. Thus, the domicile rule could result in more or less tax depending on her personal estate and gift planning.

A related item of concern expressed by these women is the "tie-breaker" test employed to determine the country of domicile for purposes of the treaty in the case of individuals who are treated by both countries as domiciliaries under their domestic laws. This concern only applies in the case of those who do not want to be treated as U.K. domiciliaries. Under the first test to determine domicile under the treaty, these women, as U.S. citizens, would be treated as U.S. domiciliaries and not U.K. domiciliaries if they were considered to have been domiciled in the United States at any time within the three years prior to death and they were not resident in the United Kingdom in 7 or more of the 10 years preceding death. If treatment as a U.S. domiciliary cannot be established by the first test, such a woman would be treated as a domiciliary of the country in which she had a permanent home available. If domicile cannot be determined under that second test, either because she had a permanent home available in both countries or in neither, she would be treated for purposes of the treaty as being domiciled in the country "with which [her] personal and economic relations were closest (centre of vital interests)." These women requested that this test be modified so that it would not depend on the individual's personal relations with the two countries but only her economic relations. This change would be unacceptable to the British because all their estate tax treaties are dependent upon both personal and economic relations in the event that it is necessary to use this tiebreaker test and because that is the test used in the OECD model tax treaty. It is also a standard

provision in U.S. estate tax treaties (including the U.S. model estate tax treaty), and it is employed in the present U.S.-U.K. estate tax treaty. Since it is the international norm, it is doubtful that it will be possible to change this test in U.S. tax treaties.

Estate and Gift Tax Treaty with France

The proposed treaty was signed by the United States and France on November 24, 1978. The portion of the proposed treaty dealing with estate taxation will replace the existing estate tax treaty and protocol between the United States and France, which have been in force since October 17, 1949. There is no existing gift tax treaty between the two countries.

In general, the proposed treaty with France is similar to the proposed treaty with the United Kingdom in its purpose, operation, and effect.

As in the case of the proposed U.K. treaty, the purpose of the proposed estate and gift tax treaty between the United States and France is to alleviate double taxation on estates and gifts of French and U.S. domiciliaries and U.S. citizens by modifying the jurisdictional rules of estate and gift taxation with respect to these individuals. The countries agree that an individual's country of domicile has primary tax jurisdiction on the estates and gifts of its domiciliaries. However, real property, business assets and tangible personal property which are located in the other country ("situs country") are generally subject to primary tax jurisdiction in the situs country.

The proposed French treaty differs from the proposed treaty with the United Kingdom in allowing primary jurisdiction to the situs country in the case of all tangible personal property, rather than only such property which is the business property of a permanent establishment. Under the U.K. treaty, primary tax jurisdiction over personal property not part of a permanent establishment is conferred on the country of domicile. However, like the U.K. treaty, the French treaty permits one country to tax on the basis of citizenship after allowing a credit for tax paid to the other country on the basis of domicile.

Also as in the case of the U.K. treaty, the French treaty modifies the domestic law jurisdictional rules of the two countries in situations where, under those laws, an individual is considered to be a domiciliary of both countries. In such circumstances, the countries agree to treat the individual

as having only one country of domicile for purposes of the taxes covered by the treaty. The treaty sets forth several criteria for purposes of determining which country is the country of domicile which in general apply concepts similar to those in the proposed U.S.-U.K. treaty.

Income Tax Treaty with Hungary

The proposed treaty was signed on February 12, 1979, and was amplified by an Exchange of Notes signed the same day. No similar treaty between the two countries is in force at the present time.

The proposed treaty is similar to other recent U.S. income tax treaties and to the model income tax treaty of the Organization of Economic Cooperation and Development (OECD) in virtually all respects.

As with the other U.S. tax treaties, its principal purpose is to reduce or eliminate potential double taxation of income earned by citizens and residents of either country from sources within the other country. The proposed treaty is intended to promote closer economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries.

As in the other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory be residents of the other. For example, the treaty contains the standard tax treaty provision that neither country will tax the business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a branch or other permanent establishment or fixed base (Article 7). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services will not be required to file tax returns and pay tax in the other unless their contacts with the other exceed certain specified minimums (Articles 13 through 18). Also, the proposed treaty provides that interest, royalties, capital gains and certain other income derived by residents of either country from sources within the other are generally to be taxed only by the country of residence and not by the country of source (Articles 10, 11, 12 and 19), and that dividends received by residents of one country from sources within the other are to be taxed at reduced rates by the country of source (Article 9).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally provides for the relief by the country of residence of the potential double taxation (Article 20) through a foreign tax credit (in the case of the United States) or an exemption (in the case of Hungary).

The treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 1). In addition, it contains the standard provision that the treaty will not be applied to deny any taxpayer any benefits he would be entitled to under the domestic law of either country or under any other agreement between the two countries (Article 24); that is, the treaty will only be applied to the benefit of taxpayers.

The treaty also contains standard nondiscrimination provisions and provides for exchanges of information and administrative cooperation between the tax authorities of the two countries to avoid double taxation and prevent fiscal evasion with respect to income taxes.

Income Tax Treaty with Korea

The proposed treaty was signed on June 4, 1976, and was amended by an Exchange of Notes signed the same day. No similar treaty is in force between the two countries at the present time.

The proposed treaty is substantially similar to other recent United States income tax treaties and to the model income tax treaty of the Organization for Economic Cooperation and Development (OECD). The proposed treaty establishes maximum rates for the U.S. and Korean withholding taxes on passive income payments flowing between the two countries. Also, a resident of one country will not be subject to tax in the other country on business profits unless those profits are attributable to a permanent establishment which the resident maintains in the other country. Similarly, for business visitors from one country temporarily present in the other, the host country may tax the vistors only if certain tests (based on time spent or amounts earned) are met.

The proposed treaty contains a special provision (Article 25), not found in other income tax treaties, which provides a special exemption from U.S. social security taxes for Korean residents who are working on a temporary basis in Guam. A similar exemption is provided in the Internal Revenue Code for Philippine residents temporarily present in Guam.

While the Korean treaty was pending before the Senate in the last Congress, several Senators expressed concern to the Treasury Department over the absence of a domestic registration, of "flag," requirement in the shipping article. However, it is understood that these concerns were allayed by Treasury's assurances that the proposed treaty would not create a tax incentive to register ships under foreign flags of convenience,

rather than the U.S. flag, and in many instances would assist U.S. flag shippers. The treaty only applies to U.S. citizens and U.S. corporations. It does not benefit a Liberian, Panamanian, or any other foreign company even if the company is wholly owned by U.S. residents.

If, on the other hand, a U.S. company is used, it will be subject to U.S. tax on its worldwide income, so the tax advantage of foreign incorporation is lost; and at the same time, it would not qualify for benefits to U.S. flag shipping, such as the capital construction fund, which require a U.S. flag.

Finally, in the related exchange of notes, the United States agrees, when feasible, to resume discussions with Korea with a would minimize the interference of the U.S. tax system with special incentives provided by Korea to promote the flow of United States capital and technology to Korea. The exchange of notes is similar in effect to the notes exchanged in connection with the U.S. income tax treaty with Trinidad and Tobago. In the same exchange of notes, the Korean Government confirmed that the definition of Korean tax for purposes of the proposed treaty includes the Korean Defense Tax assessed on the taxes referred to in that definition (i.e., the Korean income tax and corporation tax).

Conclusion

Other than the issue in the proposed U.K. protocol dealing with the drilling contractors, the proposed treaties and protocols before the Committee do not appear to present any significant items of controversy. Staff has analyzed the treaties and protocols and, in our opinion, they do not contain any provisions similar to ones which the Committee or the Senate has objected to in the past. Their provisions are substantially similar to provisions contained in other U.S. tax treaties which have in the past been considered and approved without objection by Committee and the Senate.

Senator JAVITS. Mr. Brockway, thank you very much for your testimony.

Our next witness is the Honorable Donald C. Lubick, Assistant Secretary for Tax Policy, Department of the Treasury.

Mr. Lubick, welcome to the committee. I believe the Chair has already put into effect the 5-minute rule, so we would appreciate you summarizing your testimony.

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY; ACCOMPANIED BY: JOHN RAEDEL, DEPUTY INTERNATIONAL TAX COUNSEL, DEPARTMENT OF THE TREASURY

Mr. LUBICK. Thank you, Senator Javits. With me today is Mr. John Raedel, Deputy International Tax Counsel. With your permission, I would like my prepared statement and two letters referred to therein to be incorporated into the record.

Senator JAVITS. Without objection, the statement and the letters will be incorporated into the record at the appropriate point.

TREASURY SUPPORT FOR TAX CONVENTIONS AND PROTOCOLS

Mr. LUBICK. The Treasury is in support of the four tax conventions and two protocols that are before you. In our statement we have listed the extensive treaty negotiating program into which we have entered and the importance of the tax conventions. These are important to the commercial activities of the United States and to international commercial relations, and it is for this reason that we would hope to secure prompt consideration by the Senate of these conventions. They are important in our international relations and they are important to American business operating abroad as well.

PHILIPPINE CONVENTION

I would like to spend one moment talking about a convention that is not being considered today, and this is the Philippine Convention that has been before the committee since December 1976. It is my understanding that this convention is not being considered today because it does not contain the traditional reciprocal exemption from tax of income from the operation of aircraft in international traffic. At the suggestion of the committee, we went back and tried to get the Philippines to reconsider their position and agree to a reciprocal exemption. We were unable to secure that.

We have given assurances that approval of the Philippine Convention would not be a precedent contrary to the traditional U.S. negotiating position which seeks a reciprocal exemption. There are $1 billion of U.S. investment in the Philippines. The convention is very favorable to most of that investment. We would urge that the convention not be defeated, particularly through complete inaction, solely because we were unable to negotiate a preference benefit for just one industry.

I would hope that at your next available opportunity you would be able to deal with the Philippine Convention.

MATTER OF URGENCY ON FRENCH AND UNITED KINGDOM PROTOCOLS

The most important matters before you are the French and the United Kingdom protocols. They do have a matter of urgency about them.

As to the United Kingdom protocol, you have all heard testimony regarding the parliamentary situation. Two and a half weeks ago I met in the United Kingdom with the Minister of State and reported to him that we were going to urge the Senate to proceed as quickly as possible to ratify the protocol in accordance with their suggestion. It is their suggestion that the Senate will have to act first on the protocol before they take it up. They are fully aware of the position we are taking.

SENATE WILL NOT RECONSIDER ITS POSITION ON ARTICLE 9(4)

With respect to the 9(4) issue, we have brought to their attention the *Japan Line* case and we have told them that we think it might be fruitful to proceed through litigation, and that there is a very substantial position that the result they seek to accomplish through either the treaty or legislation can be accomplished through litigation. We advised them that it was not possible to get the Senate to reconsider its position on 9(4), and I believe they understand that.

The matters that we have taken up in the United Kingdom protocol seem to have satisfied everyone with the possible exception of the drillers, and I would like to deal with those questions along the same lines as Mr. Brockway.

UNITED KINGDOM JUSTIFIED IN TAXING DRILLING ACTIVITIES

First of all, as a matter of tax policy, as Mr. Brockway has indicated, there is nothing unusual or unjustifiable about the United Kingdom taxing and having primary jurisdiction to tax these activities in the United Kingdom. They are significant activities and they are within the general concept underlying the permanent establishment criterion for taxation.

The United Kingdom takes the position, and we believe a substantial case can be made for it, that even if there were no protocol, the same result would be reached. We have only confirmed that which is already clear under the possibility of United Kingdom statutory law and the existing treaty and protocols, that the United Kingdom is entitled to tax these activities as the conduct of business through a permanent establishment in the United Kingdom.

We are also uncertain whether, in fact, there is any harm to U.S. taxpayers in this matter. We have requested in March some specific information from the drillers. It has not been forthcoming. We wanted to see whether indeed many of these drillers would obtain greater benefits under the treaty than any possible loss through a higher rate of British taxation. This has not been forthcoming.

I suspect that on balance the United Kingdom is justified and that there is very little harm, if any, if the United Kingdom decides to go ahead and tax. What we are talking about is United Kingdom tax, possibly at a 52-percent rate, credited only at a 46-percent rate under our statute. You are talking about a small difference. But again, they

operate through subsidiaries in the United Kingdom and if there are distributions of that United Kingdom income, they will receive credits under the United Kingdom system. So, in the long run, I would suspect that there is practically no difference.

Senator JAVITS. Thank you, Mr. Lubick. Would you provide this committee with the following information, in memorandum form, if possible. One is the fact that the period of time specified and the procedure followed is an entirely usual practice in our country and many others and that the 30-day period is not a discriminatory exaction on American drillers.

The second point involves the de minimis nature of this proposition, which it prompts an immediate question. Considering the high national interest in seeing this treaty approved—and, as you know, I have fought for this treaty out of no interest other than my belief that it is best for our country—do you think the British would insist on this provision in view of the fact that they believe they have the right under the treaty to tax the drillers?

Mr. LUBICK. We do, Senator Javits. We believe their position is justified. We would be very hard-pressed to ask them to change it.

Senator JAVITS. So, the point that I made before, that the Treasury will not renegotiate this position, is affirmed?

Mr. LUBICK. That is correct. we will submit the information which you request.

[Additional questions and answers follow.]

MR. DONALD C. LUBICK'S ANSWERS TO ADDITIONAL QUESTIONS SUBMITTED BY SENATOR JAVITS

Question 1. Article VI of the Third Protocol to the U.S.–U.K. income tax treaty contains a provision which permits the taxation of activities connected with the exploration or exploitation of the seabed and subsoil and their natural resources after a period of 30 days in any twelve month period. Is this unusual?

Answer. As a matter of United States tax policy there is nothing particularly unusual or unjustifiable about a provision which preserves a country's right to tax exploration or exploitation connected activities after a 30-day period.

Congress, in the Tax Reform Act of 1969, enacted section 638 of the Internal Revenue Code specifically to assure that the United States would be able to tax natural resource exploration and exploitation activities conducted in the continental shelf areas of the United States.

Under domestic tax law, the United States' right to tax the income from such activities is not limited by any time requirement. Generally, a foreign company is taxable in the United States on its income effectively connected with the conduct of a trade business in the United States even if that trade or business lasts no more than one day. It seems to us difficult to argue that the United Kingdom should not have a similar right to tax.

In addition, preservation of a right to tax the income derived from business activities without any time threshold is not an unusual provision as a matter of treaty policy. Both the United States model income tax treaty and that of the Organization for Economic Co-operation and Development (OECD) provide, as a general rule, for the taxation of business profits attributable to a permanent establishment without specifying any time requirement before which there can be no permanent establishment.

Question 2. Will Article VI of the Third Protocol adversely affect U.S. taxpayers in a significant way?

Answer. This provision in large, if not full measure, represents merely a Treasury-to-Treasury transfer of revenue which should not have a material impact on U.S. taxpayers.

Under this provision, the income from these exploration or exploitation connected activities in the United Kingdom could be taxed by the United Kingdom. Under both the proposed treaty and our tax law, a United States company subject to this United Kingdom tax would be entitled to claim a foreign tax credit against its U.S. tax liability for the U.K. tax which may be imposed. There should be

no double taxation in these circumstances. Tax on the income is paid only once, to the U.K. treasury. While it is true that the statutory corporate tax rate in the U.K. is higher than that in the U.S.—52 percent vs. 46 percent, it should be noted that at most there is only a potential excess foreign tax credit of 6 percent. But even this potential excess credit is mitigated further by other factors. By virtue of a variety of provisions of U.K. tax law, the U.K. effective tax rate may well be less than 52 percent and our overall foreign tax credit limitation would permit the U.S. company to offset any excess foreign tax credit on this income against the U.S. tax liability on any other lower-tax income from other foreign countries which the U.S. company may have. On balance, we do not believe this provision will adversely affect U.S. taxpayers in any material way.

Moreover, we have repeatedly asked the drilling industry representatives to explain specifically why they would be adversely affected and we have not received any hard evidence from any company of specific harm. Indeed, our impression is that the concern expressed over this provision is not an industry-wide one, but rather that of only a few companies.

Senator JAVITS. That would be very helpful. We have a meeting scheduled for next Wednesday at which we will discuss this treaty.

Mr. LUBICK. We made the points in a letter to each member of the committee, and we will provide the information for insertion into the record.

Senator JAVITS. Especially the de minimis problem.

Mr. LUBICK. Yes.

[The letter referred to above follows:]

DEPARTMENT OF THE TREASURY,
EMBASSY OF THE
UNITED STATES OF AMERICA,
May 18, 1979.

MRS. ANNE SMALLWOOD,
Inland Revenue,
Somerset House, The Strand,
London, WC 2.

DEAR MRS. SMALLWOOD: In the course of discussions between delegations of the United States Department of the Treasury and the United Kingdom Inland Revenue on the Convention between 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 Notes exchanged at London on April 13, 1976, and by Protocols signed at London on August 26, 1976, March 31, 1977, and March 15, 1979 (the Convention as amended by the Notes and Protocols being hereinafter referred to as the "Convention"), you indicated that you did not interpret paragraphs (1) and (2) of Article 2 (Taxes Covered) of the Convention to encompass the taxes imposed under Sections 1401, 3101, and 3111 of the Internal Revenue Code of 1954, as amended, since these taxes are in effect Social Security Insurance contributions. You noted that, notwithstanding paragraph (2) of Article 23 (Elimination of Double Taxation) of the Convention, the laws in force in the United Kingdom would not allow the granting of a credit against a taxpayer's United Kingdom tax liability for amounts of such taxes paid to the United States.

In view of the foregoing, we agreed that neither the United States Department of the Treasury nor the United Kingdom Inland Revenue would interpret paragraphs (1) and (2) of Article 2 (Taxes Covered) of the Convention to include taxes imposed under Sections 1401, 3101, and 3111 of the Internal Revenue Code.

If the foregoing is in accordance with your understanding of the interpretation of paragraphs (1) and (2) of Article 2 of the Convention, the United States Department of the Treasury will consider this letter, together with your letter in reply to it, as confirming the official views of our two Departments.

Sincerely,

H. DAVID ROSENBLOOM.
Director, Office of International Tax Affairs.

INLAND REVENUE,
SOMERSET HOUSE,
LONDON, WC2R 1LB,

Mr. H. DAVID ROSENBLOOM, *May 21, 1979.*
Director, Office of International Tax Affairs, Department of the Treasury, Washington, D.C.

DEAR MR. ROSENBLOOM: In reply to your letter of 18 May 1979, I am writing to confirm our agreement with the interpretation of paragraphs (1) and (2) of Article 2 of the Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains between our Countries which was signed on 31 December 1975 and amended by Notes exchanged on 13 April 1976 and by Protocols signed on 26 August 1976, 31 March 1977 and 15 March 1979.

There is no power under United Kingdom law, to which Article 23 of the Convention refers, to allow credit against United Kingdom tax for the taxes imposed under Sections 1401, 3101 and 3111 of the IR Code of 1954 as amended. From the United Kingdom point of view they cannot therefore be covered by the Convention, and we accept your conclusion that neither country should interpret paragraphs (1) and (2) of Article 2 of the Convention as including those taxes.

This letter together with yours of 18 May 1979 will be taken as confirmation by the United Kingdom Inland Revenue of the official views of our two departments.

Yours sincerely,

Mrs. A. H. SMALLWOOD,
Commissioner of Inland Revenue.

PROTOCOL TO U.S.-FRANCE CONVENTION

Let me turn briefly to the convention between the United States and France, and the protocol to that. Again, we are dealing with a sticky question of double taxation under French law and U.S. law. This applies to Americans who are resident in France. They are U.S. citizens and therefore are subject to taxation in the United States on the basis of citizenship. Much of their income for U.S. purposes is U.S. source income. So normally we would not give a foreign tax credit for a French tax based on that income.

The protocol carves up the disputed area in what we believe is a reasonable way. I believe that most of our citizens in France are satisfied with it and are urging you to proceed. There is urgency in this matter because the new French mode of taxation has taken effect.

The convention between the United States and Hungary follows very closely our U.S. model, so there should be no particular problem.

NO PROBLEMS PRESENTED BY KOREAN TREATY

The Korean Treaty also does not seem to present any particular problem. Some questions were raised about the social security exemption and we think it is consistent with our policy. We have negotiated recently another protocol with the Soviet Union which gives some exemptions for social security taxes, in those cases where it is unlikely that the employees will ever receive benefits. We think that Korea should go ahead.

ESTATE TAX CONVENTIONS BETWEEN UNITED STATES-UNITED KINGDOM AND UNITED STATES-FRANCE

The two estate tax conventions involving the United States and the United Kingdom, and the United States and France, are necessary because they reconcile the new U.S. estate and gift tax laws adopted in 1976 with the foreign tax rules, and establish the current U.S. treaty position of taxing primarily on the basis of domicile rather than on the basis of the situs of property. We have heard no objection to these Treaties and would urge that you go ahead on that basis.

If there are any questions, I would be pleased to deal with them.

[Mr. Lubick's prepared statement follows:]

STATEMENT BY DONALD C. LUBICK
ASSISTANT SECRETARY FOR TAX POLICY
DEPARTMENT OF TREASURY
BEFORE THE
SENATE FOREIGN RELATIONS COMMITTEE
WASHINGTON, D.C.

Mr. Chairman and members of the Committee:

I am very pleased to appear before your Committee today in support of four Tax Conventions and two Protocols to Tax Conventions currently pending before the Senate. The four proposed Tax Conventions are: an Income Tax Convention with Korea, an Income Tax Convention with Hungary, an Estate and Gift Tax Convention with the United Kingdom and an Estate and Gift Tax Convention with France. The two Protocols would amend the proposed Income Tax Convention between the United States and the United Kingdom and the existing Income Tax Convention between the United States and France.

General Remarks

Before discussing these Protocols and Conventions I would like to briefly highlight the development of the U.S. tax convention program since the Treasury last appeared before this Committee on the subject of tax conventions in July of 1977. Since that time, we have continued to work to expand and improve the U.S. tax convention network. In the last two years, we have been engaged in discussions with twenty-six countries* and have had preliminary communications with several others. This represents an

*/ Argentina, Australia, Bangladesh, Canada, Costa Rica, Cyprus, Denmark, Egypt, France, Germany, Hungary, India, Israel, Italy, Jamaica, Japan, Malta, the Netherlands, New Zealand, Nigeria, Norway, the Philippines, the Union of Soviet Socialist Republics, Sri Lanka, Tunisia and the United Kingdom.

increase in the level of our activity on tax conventions which is attributable to several factors.

First, our experience during this period has been that more U.S. taxpayers are becoming aware of the value and importance of tax conventions - both as vehicles for confirming and clarifying the rules of taxation which apply to economic transactions between the two contracting states and as a means of facilitating the harmonization of different tax systems in order to resolve conflicts and to avoid double taxation. Both of these functions of a tax convention help to mitigate impediments to the free flow of capital and technology and to simplify the business decision-making process.

Second, the advantages of a tax convention are also becoming apparent to more foreign governments. Tax conventions, through their provisions for the exchange of information and mutual agreement procedures, are useful tools in the effort to reduce international tax avoidance and evasion and provide a formalized means for cooperation between the tax authorities of the contracting states. Moreover, developing countries seem more aware that an income tax convention with the United States signals a positive attitude toward U.S. investment and, as such, may help to stimulate such investment.

Third, the Treasury has taken several steps which support the increased interest in tax conventions. We have publicized tax convention negotiations and have created opportunities for public participation during the process of negotiating a tax convention.

A tax convention is negotiated on behalf of the United States by representatives of the Treasury in consultation with the Department of State. Typically, our counterparts in a negotiation are representatives of the foreign tax administration. The public does not participate in the actual government-to-government discussions. However, we have undertaken to keep the public aware of our scheduled negotiations and to provide the public with information about the positions we might be taking in particular negotiations. We have tried to accomplish this objective through several means.

It has been our practice during recent years to issue news releases identifying the countries where we are engaged in active negotiations. These news releases are published in the Federal Register and Treasury solicits comments from those with an interest in the particular countries involved.

The Treasury also has invited public participation at open meetings on specific tax conventions. These public meetings typically take place at a time when negotiations make it appear likely that a convention will be concluded. Generally, we like the negotiations to have proceeded to the point where we have a reasonably full understanding of those aspects of the foreign tax law which should be addressed. The purpose of these public meetings is to learn about the experiences and problems of U.S. taxpayers in the foreign jurisdiction and to discuss, in general terms, the Treasury's negotiating objectives. When possible, we also try to indicate where it may be necessary to deviate from the United States' preferred negotiating position which is embodied in the U.S. Model Income Tax Convention which itself has been in the public domain since 1975. The U.S. Model, which was last revised in May of 1977, is similar, in many respects, to the Model Income Tax Convention published by the Organization for Economic Cooperation and Development. The United States also published a Model Estate and Gift Tax Convention on March 16, 1977. The United States is the only country which publishes its model tax conventions.

Another step that the Treasury takes to involve the public is to release a proposed tax convention to the public as soon as it has been signed. This gives the public an opportunity to comment on the specific provisions of the convention before it is actually submitted to the Senate.

Finally, this increased activity can be attributed, in part, to changes in the tax laws of either the United States or the foreign jurisdictions. Several of the Conventions and Protocols you are considering today were prompted by such changes.

The negotiation of the proposed Income Tax Convention with the United Kingdom, which this Committee examined in 1977, began as a result of a change in United Kingdom law. In 1973, the United Kingdom changed its law from a classical system of taxation -- where corporations and their shareholders are taxed separately -- to a partially integrated system where the taxation of corporate profits is partially mitigated by crediting to shareholders taxes paid on the

corporation's earnings. The change in the United Kingdom law discriminated against U.S. investment and the Treasury sought a modification of the Convention to eliminate the discrimination. Today, we will be discussing a Protocol to this proposed Convention.

The Protocol to the existing Income Tax Convention with France is also an example of a revision that is needed because of a change in foreign law. Effective January 1, 1979, France will have a new tax law that significantly changes the French income tax liability of U.S. persons who reside in France. The Protocol is necessary to relieve the double taxation that will result when the new French law comes into effect.

New conventions may also be necessary when the United States changes its tax law. For example, in 1976 the estate tax law of the United States changed significantly. The modifications in U.S. law have made it necessary to re-examine the vitality of U.S. estate tax conventions. The two proposed estate tax conventions currently before this Committee are the first to reflect the 1976 changes.

As you can imagine, changes in either U.S. or foreign tax law that are important enough to warrant a modification of an existing tax convention also warrant prompt action. Our goal in such cases is to make certain that a protocol or new convention is negotiated as soon as possible. And, we may request that the modification provide relief from the change in the tax law back to the time of its initial application. That is the way the proposed Income Tax Convention with the United Kingdom is designed. The proposed Protocol with France also has that objective.

Providing taxpayers with this type of retroactive protection can, however, create problems. For example, the proposed Convention with the United Kingdom has an effective date that goes back in some cases to 1973. Assuming that the Convention comes into force in 1979, the tax authorities of the United States and the United Kingdom will have to cope with amendments to tax returns for as many as six years. In the case of the French Protocol, the effective date is also fixed: January 1, 1979, the time when the new legislation takes effect.

The ability to respond quickly is important to the U.S. tax convention program. We must be able to react to changes in foreign and U.S. law in a manner that allows a protocol

or new convention to address a problem from its inception and to do so in a timely fashion. If a proposed protocol or convention that is retroactive ages before coming into force it creates uncertainty and problems of administration. If a protocol or new convention is not retroactive to the date of the new foreign law, then delaying its negotiation or ratification prevents the treaty's protection from applying to the full period where taxpayers are affected. In either case, delay causes the U.S. tax convention program to be less than fully effective. In this regard, the cooperation of this Committee and of the Senate is of the utmost importance.

We are grateful to the Committee for taking up this group of Conventions at this time. We hope that your action will allow the Senate to focus on and consent to these agreements soon.

I would like to spend a moment on the proposed Income Tax Convention between the United States and the Republic of the Philippines. That Convention was submitted to this Committee in December of 1976 and is not being considered today. I understand the Philippine Convention is not being considered today because it does not contain our traditional reciprocal exemption from tax of income from the operation of aircraft in international traffic. I think the Committee should know that in 1978, at the request of the affected U.S. airlines, Treasury again proposed that the Philippine Government reconsider its position and agree to a reciprocal exemption. The Philippines again rejected our proposal.

The Committee should not be concerned that approval of the Philippine Convention would set a precedent contrary to the traditional U.S. position of exemption for profits of international airlines. Indeed, it was to protect the position of exemption that it was decided that the Convention should not cover airlines at all. President Carter discussed this issue in an August 8, 1977 letter to Senator Church. President Carter stated that we do not regard the Philippines treaty as a precedent on the airlines issue and gave his assurance that the Treasury Department in subsequent negotiations would insist strenuously on a reciprocal exemption.

There is a billion dollars of U.S. investment in the Philippines, and the proposed Convention contains provisions favorable to most of that U.S. investment. I believe that a

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Convention which is generally sound and favorable to U.S. investment ought not to be defeated -- especially by inaction -- merely because it does not obtain the preferred benefit for just one industry -- the airlines. I strongly urge this Committee to consider the proposed Convention with the Philippines soon and to report it to the Senate for its consideration on the merits.

I would now like to summarize the important features of the six Conventions and Protocols. A full explanation of each of these agreements has been prepared by the Department of the Treasury. Those explanations have been submitted to the Committee.

Third Protocol to the Proposed Income Tax Convention between the United States and the United Kingdom

The proposed Income Tax Convention with the United Kingdom was signed on December 31, 1975, and amended by an Exchange of Notes signed on April 13, 1976 and Protocols signed on August 26, 1976 and March 31, 1977. On June 24, 1976, President Ford transmitted the proposed Convention and the Exchange of Notes to the Senate for its advice and consent. The Protocols were subsequently transmitted to the Senate and were considered by it along with the Convention and Exchange of Notes.

On June 27, 1978, the Senate, by a vote of 82 to 5, passed a resolution of ratification with a reservation proposed by Senator Church on Article 9(4). Article 9(4) would have restricted the power of the states of the United States to apply the unitary method of taxation to British multinational companies.

Subsequent to the Senate's approval of the Convention with the reservation on Article 9(4), discussions were held between representatives of the U.S. Treasury Department and the U.K. Inland Revenue. The Third Protocol, which was signed on March 15, 1979, is a product of those discussions. After approval of the Third Protocol by the Senate the United Kingdom House of Commons must approve both the proposed Convention with Article 9(4) modified and this Third Protocol before the two documents will come into force.

The proposed Convention contains a number of significant benefits to both countries. Chief among the benefits to U.S. taxpayers is the provision for payment to United States

investors in United Kingdom corporations of amounts in respect of the U.K. Advance Corporation Tax.

The Protocol essentially does three things:

(1) It conforms the Convention to the Senate reservation;

(2) It limits the amount of the U.K. Petroleum Revenue Tax ("PRT") allowable as a credit against U.S. tax liability;

(3) It provides for a special rule pertaining to the taxation of activities carried on in connection with the exploration or exploitation of the seabed or subsoil and their natural resources.

The Protocol also makes a number of technical corrections and clarifications.

Conformity with Senate Reservation

Article I of the Protocol conforms the text of the Convention to the Senate reservation proposed by Senator Church on Article 9(4), which dealt with the so-called unitary method of taxation employed by some of the states of the United States. The Protocol, when ratified by Parliament, will thus memorialize British acceptance of the Senate reservation. States of the United States would not be prohibited from use of the unitary method, although each of the national governments of the two countries obligates itself not to use such a method.

Limitation of the Creditability of the Petroleum Revenue Tax

During the Senate debate on the Convention, Senator Kennedy expressed concern that the Convention would permit United States oil companies to shelter oil related income from operations in OPEC countries with excess PRT made creditable by the Convention. Senator Kennedy withdrew his proposed reservation on this problem based upon an undertaking given by the Treasury to negotiate a suitable limitation on the creditability of the PRT. Article V of the Protocol addresses Senator Kennedy's concern by limiting the creditable PRT by a formula which is based on United Kingdom source taxable income which is subject to the PRT. Thus excess PRT will not spill over to offset U.S. tax on income from other countries.

Taxation of Offshore Activities

As a concession for Senate rejection of Article 9(4), the United Kingdom requested a special rule clarifying the right of a state to tax activities carried on in connection with the exploration or exploitation of the seabed or subsoil and their natural resources. The proposed Convention does not now have a permanent establishment rule specifically dealing with offshore activities and it was not clear how other permanent establishment rules in the Convention would apply to such activities.

Under ordinary rules generally governing "permanent establishments" and "fixed bases" substantial amounts of income derived from activities connected with exploration or exploitation of the seabed or subsoil might escape taxation even though there is a significant economic connection with a contracting state. Some of the offshore activities in question are mobile in nature, allowing the operator and equipment to spend a short period of time within a state. To further complicate matters, the North Sea is bounded by several countries. A taxpayer could easily earn substantial amounts of income in one sector and then move to another.

Under these circumstances, the United States agreed to draft a rule that would allow the source jurisdiction to impose tax after an offshore activity is carried out in a country for more than 30 days in a twelve month period. This rule is reciprocal and will allow the United States to tax residents of the United Kingdom engaged in natural resource exploration or exploitation on the United States Continental Shelf for more than 30 days in a twelve month period.

A concern expressed by some companies affected by this new provision is that it would unfairly subject them to potential taxation in the United Kingdom. We believe to the contrary, that it is a reasonable and justifiable provision. Its effect, in the first instance, is to allocate, as between the British and United States Treasuries, the tax revenues derived from the covered North Sea activities. The United Kingdom, as the source jurisdiction, should have the primary right to these revenues. Moreover, under either the Convention or our tax law, a U.S. company subject to tax in the United Kingdom would be entitled to claim a foreign tax credit against its U.S. liability for U.K. tax which may be imposed. Any inability of the U.S. company to utilize this

foreign tax credit would be due to the limitations of the Internal Revenue Code, which reflect the Congressional intent not to allow excessive credits.

Finally, absence of such a rule could lead to international tax avoidance because of the mobile nature of the activities in question.

Social Security

I would like to note for the record that during the course of discussions on the Third Protocol, the United Kingdom delegation drew our attention to a misstatement in the Treasury's Technical Explanation of the Convention. Neither the U.K. nor the U.S. intended the Convention to apply to the Social Security taxes imposed under sections 1401, 3101 and 3111 of the Internal Revenue Code. The exchange of correspondence between the U.S. Treasury and the U.K. Inland Revenue submitted with this statement confirms the correct interpretation of Article 2 of the Convention.

Almost three-and-a-half years have passed since the Convention was signed on December 31, 1975. The delay in bringing the Convention into force is creating problems both for taxpayers and the tax administrations of both countries. Many of the rules in the Convention would apply retroactively. Elimination of uncertainty as to which rule applies to a particular transaction is one of the reasons we urge prompt action on the Protocol. We have been informed that the Ministers of the United Kingdom Government will not present the Protocol and the proposed Convention to Parliament for ratification until the U.S. Senate has acted.

Protocol to the Income Tax Convention between the United States and France

The Protocol to the Income Tax Convention with France modifies that Convention in several respects, the most important of which is to prevent double taxation of U.S. citizens who are residents of France. Under French law prior to this year, U.S. citizens residing in France have been subject to French tax only on their French source income. Since the French tax on French income is creditable against their U.S. tax liability, no double taxation arose.

As of January 1, 1979, U.S. citizens living in France will be taxed by France like other French residents on their worldwide income. France will give a credit for the tax

paid by U.S. citizens to the United States on income from U.S. sources, but only for the tax which the Convention allows the United States to impose as the country of source and not for any higher tax that the United States may impose on the basis of citizenship. (The Convention reductions in U.S. tax apply to residents of France who are not U.S. citizens; the United States does not in the Convention reduce its tax on U.S. citizens.) Since the United States will not credit French tax on U.S. source income, cases of serious double taxation could arise.

The United States and France have arrived at a solution to the problem that has the two jurisdictions share the responsibility for avoiding this double taxation. France agrees to exempt some U.S. income of U.S. citizens from its tax, even though under the Convention the United States would be required to exempt such income if the recipient were not a U.S. citizen. And the United States agrees to treat as French source income, eligible for a foreign tax credit, that portion of income arising in the United States on which the U.S. tax exceeds the tax which the United States could impose if the recipient were not a U.S. citizen. For example, France agrees to exempt from tax income of a U.S. citizen resident in France for personal services performed in the United States for periods of less than six months (183 days) of the year. And when such an individual receives U.S. dividends, France will give credit for a 15 percent U.S. tax (the withholding rate under the Convention) and the United States agrees to credit the net French tax in excess of that credit.

Special rules were also needed to coordinate the source and taxing rules with respect to partnership income.

The Protocol also reciprocally eliminates the tax withholding at source on interest on bank loans, a step consistent with the U.S. Model Income Tax Convention. And it removes the flag test for exemption at source of income from international transport, also in accordance with the U.S. Model. This provision does not reduce U.S. tax on U.S. companies or French tax on French companies.

Because of the importance of the provisions to avoid double taxation, the Protocol is drafted to take effect as of January 1, 1979 to coincide with the change in French law.

Income Tax Convention between the United States and Hungary

The proposed Income Tax Convention with the Hungarian People's Republic is a new convention. No tax convention is now in effect between the United States and Hungary. The proposed Convention follows very closely the provisions of the U.S. Model. In some instances portions of the U.S. Model have been deleted or moved to the Exchange of Notes because the Hungarian delegation found the language of the Model more detailed and illustrative than necessary. But there was general agreement on the principles to be applied.

With respect to rates of tax withholding at source on dividends, interest and royalties, the Hungarian Convention conforms to the U.S. Model: 15 percent on portfolio dividends, 5 percent on dividends paid by a 10 percent or more owned subsidiary to its parent corporation, and exemption at source (i.e., taxation only by the residence state) for interest and royalties. The Convention includes a comprehensive nondiscrimination article and procedures for cooperation between the tax authorities of the two countries. Both countries view the Convention as significant both to sound tax relations and as a contribution to the rapidly expanding economic relations between the United States and Hungary.

Income Tax Convention between the United States and the Republic of Korea

The proposed Convention with Korea was signed on June 4, 1976. This Committee heard testimony on the Convention during its hearings on July 19 and 20, 1977. The Committee subsequently reported favorably on the Convention, but no action was taken by the Senate.

The Convention deviates only in minor respects from the general pattern of U.S. conventions negotiated with developing countries. I would call to the Committee's attention only the following few provisions.

Social Security Exemption

One provision not found in any other U.S. income tax convention is a special exemption from U.S. social security taxes for Korean residents who are temporarily present in Guam. A similar 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 Convention for Korean residents. The Convention 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 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 Convention establishes maximum rates of withholding tax in the source country on dividends, interest and royalties flowing between the two countries. The rate of tax withholding 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 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. Royalties are subject, in general, to a 15 percent maximum rate of tax. However, the tax on literary and artistic royalties, including motion picture royalties, is limited to 10 percent.

Exchange of Notes

Notes were exchanged by the United States and Korea at the time of the signing of the Convention which deal with two subjects -- incentives for investment in Korea, and the Korean Defense Tax. During the negotiations, Korea expressed its desire to include in the Convention 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 United States 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 the one signed in 1970 at the time of the signing of the Income Tax Convention with Trinidad and Tobago.

The Korean Defense Tax is an 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 Convention include those parts of the Defense Tax which are related to the income and corporation taxes. This means that under the Convention any U.S. resident who is exempt by Convention from Korean income or corporation tax is also free of any related Defense Tax liabilities.

Estate and Gift Tax Convention between the United States and the United Kingdom

The proposed Estate and Gift Tax Convention with the United Kingdom is the first to be signed by the United States since U.S. estate and gift tax laws were modified by the Tax Reform Act of 1976. The 1976 modifications include combining the separate estate and gift tax rates into a single unified schedule, substituting a unified credit for the formerly separate estate and gift tax exemptions, and imposing a tax on generation-skipping transfers. The Convention recognizes the importance of these modifications by being applicable to the Federal taxes on estates, gifts, and generation-skipping transfers. The Convention would replace the existing Convention between the two countries which has been in effect since July 25, 1946, and which applies only to estate taxes.

In addition to reflecting recent legislative changes, the Convention also comports with our current treaty position of taxing primarily on the basis of domicile, rather than on the basis of situs. The 1946 Convention, by way of contrast, contains a comprehensive set of situs rules which eliminate double taxation by giving the primary right to tax a given type of property to the country of situs. The country of domicile, or citizenship, has the residual right to tax, provided it credits tax imposed by the other contracting state on a situs basis.

The proposed Convention, with its emphasis on domicile-based taxation, is similar in principle to the United States Estate Tax Convention with the Netherlands, which entered

into force in 1971, the U.S. Model Estate and Gift Tax Convention and, in part, the Model Estate Tax Convention published in 1966 by the Organization for Economic Cooperation and Development.

The general principle underlying the proposed Convention is that the country of domicile may tax the estate or other transfers on a worldwide basis with a credit for tax paid to the other country with respect to certain types of property located therein. Specifically, immovable property and certain business assets are taxable in the country where situated. The Convention also allows the country of citizenship the right to tax the worldwide estate or other transfers, with a credit for tax paid to the other country on either a domiciliary or a situs basis.

The Convention provides rules for determining which country has the right to tax on a domiciliary basis when a decedent or transferor is domiciled, under the laws of the respective countries, in both countries at the time of death or transfer. It provides that a U.S. citizen, who at the time of death or transfer is considered under the Convention to be domiciled in both the United Kingdom and the United States, shall be deemed to be domiciled in the United States if he had not been resident in the United Kingdom in 7 or more of the 10 income tax years of assessment ending with the year in which the death or transfer occurs. The effect of this rule is that the United Kingdom may not subject the estate or transfers of a U.S. citizen and domiciliary to tax on a worldwide basis if he has been resident in the United Kingdom for less than 7 out of the 10 years ending with the year in which the death or transfer occurs. This rule is based upon the concept that a country should not tax the estate or other transfers of an individual on a domiciliary basis if the individual has not been present in that jurisdiction for a significant period of time.

The Convention is subject to ratification by the two Governments. Once ratified, it will enter into force on the thirty-first day after instruments of ratification are exchanged and will have effect in the United States with respect to estates of individuals dying and transfers taking effect after that date.

Estate and Gift Tax Convention between the United States and France

The proposed Estate and Gift Tax Convention between the United States and France, signed November 24, 1978, is designed to replace the existing Convention, which was signed on October 18, 1946, as modified by the Protocol of May 17, 1948, and the Convention of June 22, 1956.

The proposed Convention with France is similar to the proposed Convention with the United Kingdom, and would accomplish many of the same purposes. Like the proposed United Kingdom Convention, the proposed Convention with France would replace a convention applicable only to estates and inheritances with a convention applicable to estates, inheritances, and gifts as well as to the new generation-skipping transfer tax. The proposed Convention with France, again like the proposed Convention with the United Kingdom, would replace a situs-oriented convention with a convention which comports with current treaty policy of taxing primarly on the basis of domicile.

The rules in the proposed Convention with France for determining which state has the right to tax on a domiciliary basis are similar to those contained in the proposed United Kingdom Convention, although the rules in the proposed French Convention are slightly more restrictive of the right of the country of citizenship to tax. These rules provide that a U.S. citizen, who at the time of death or of a transfer is considered to be domiciled in both France and the United States under the internal law of each, is to be deemed domiciled in the United States if he has not been domiciled in France more than five years of the seven year period ending with the year of death, or of the gift or transfer, if the citizen has a clear intention of retaining his domicile in the United States.

There are two situations where a U.S. citizen will be deemed domiciled in the United States regardless of whether he has a clear intention of retaining his U.S. domicile: 1) if he has been domiciled in France for less than five years of the seven year period ending with the year of his death, or of the making of a gift, and if the person is in France by reason of an assignment of employment; and 2) if the citizen has been domiciled in France for less than seven years of the 10-year period ending with the year of his death, and he is in France by reason of a renewal of an assignment of employment. These domicile rules are reciprocal. Like the rules in the proposed United Kingdom

Convention, they reflect the view that a state's right to impose a tax on a lifetime accumulation of an individual should not depend upon momentary circumstances of where that person is residing at the time of his death or when he transfers his property by gift.

A second important feature of the proposed Convention is that it assures that gifts made by U.S. persons of property situated in France to U.S. charities will qualify for an exemption from tax in France. In the past, considerable doubt has surrounded the question of whether gifts of French property to U.S. charities would qualify for a deduction or exemption from French gift tax. Under the current Convention, both states agree to exempt, or give a deduction for, any property otherwise taxable by one state donated to a qualified charity in the other state, if that charity would qualify for tax exempt status in the first state.

Senator JAVITS. Thank you, Mr. Lubick. You have very thoroughly provided us with a review of the tax treaty situation.

CITATION AND DECISION IN JAPAN LINE CASE

I have two questions. The first involves the *Japan Line* case that was mentioned. Where was that decided? What was the citation?

Mr. LUBICK. It was decided by the U.S. Supreme Court. It was cited for the record by Senator Cook.

Senator JAVITS. Oh, yes; that is right.

TREASURY'S POSITION OF MATHIAS BILL

Next, under those circumstances, what is your opinion of Senator Mathias' bill? Do you want to give us that, or will the Department give it?

Mr. LUBICK. The Department in Article 9(4) of the proposed United Kingdom Treaty as originally drafted before the Senate Reservation on the Third Protocol agreed with the British to a position which achieved results similar to those in Senator Mathias' bill. So obviously we consider his bill as moving in the right direction.

We have had some discussions with the States and with various industry representatives on this matter, and indeed there are other positions which we think can be the basis of a compromise between the States and the Federal Government which might put some limit on the taxation by the States of foreign enterprises in those cases where there is no contact with the State. For example, one could isolate the situation where there is direct dealing between the parent and the subsidiary, and use this as a possible basis for differentiation.

Generally, we are favorably disposed to the legislation, but we recognize that there is a problem of the power and jurisdiction of the States to tax. We think there should be some limitation so that there is no undue burden on foreign commerce.

ADMINISTRATION POSITION ON UNITED STATES-UNITED KINGDOM TREATY

Senator JAVITS. My other question is a brief one. In respect of the United States-United Kingdom treaty, does the administration now consider, does the President now consider the treaty to be in such balance in terms of problems, such as to the one raised by the drillers, and in terms of advantages, such as the retroactive refund of over $500 million to many U.S. investors in the United Kingdom, that it is in the highest national interest of the United States that this treaty should now be ratified. If you are not in a position to speak for the administration, please do not hesitate to say so.

Mr. LUBICK. At your request a few weeks ago when we met, I took the matter up with the White House. This is the White House position. They are very anxious to have this go forward. They think it is in the best interests of the United States. The President would like to see the Senate move quickly and expeditiously on the United Kingdom treaty as well as the others.

Senator JAVITS. Thank you, Mr. Lubick.

Let me say to the other witnesses that I have a problem which requires me to momentarily recess this hearing. I must leave for another matter. I believe Senator Church will be back within a few minutes.

He is due to be back here at 11:30. I would hope that the witnesses would simply stand by until his arrival.

Our next witness is Mr. Irving Davis, a member of the Accounting and Tax Committee of the International Association of Drilling Contractors. He will be accompanied by Tom Anderson and Jon Bednerik of the association.

These gentlemen will be followed by Mr. Guttentag of Arnold & Porter; Mr. Bruce Walker, of the California Franchise Tax Board; and Mr. Samuel Lanahan of Wilmer, Cutler & Pickering.

Gentlemen, I apologize for these delays. We have had a terribly distracting morning.

Mr. Lubick and Mr. Brockway, before I leave, let me say that Senator Helms has some questions which he would like to ask you. Would you please stand by for Senator Helms.

[Pause.]

Senator JAVITS. I understand that Senator Helms will likely arrive before the chairman and will therefore convene our hearing. It should be but a moment or two.

This committee will stand in recess until the return of the Chair.

[A brief recess was taken.]

Senator HELMS [presiding]. The committee will come to order.

I understand we have heard already from Mr. Brockway and Mr. Lubick. I do have a few questions to ask these gentlemen and I would request that they respond to them for the record.

In fact, the Chair will ask all witnesses who have appeared here today and who will appear to respond to questions that may be submitted to them in writing.

[Additional questions and answers follow:]

DEPARTMENT OF TREASURY'S ANSWERS TO ADDITIONAL QUESTIONS SUBMITTED BY SENATOR HELMS

Question 1. What is the U.S. Model Tax Treaty recommended language concerning the length of time before a construction activity is considered sufficient for the "permanent establishment" test?

Answer. Paragraph 3 of Article 5 (Permanent Establishment) of the U.S. model income tax treaty published on May 17, 1977 provides that:

"3. A building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or development of natural resources, constitutes a permanent establishment only if it lasts more than 24 months."

The provision in the proposed income tax treaty with the United Kingdom which was approved by the Senate last year states that:

"(2) The term "permanent establishment" shall include especially:

"(f) a building or construction or installation project which exists for more than 12 months."

Several important conclusions can be drawn from a comparison of these provisions.

First, the U.S. model treaty only sets out the preferred United States negotiating position. We fully recognize that in negotiating a treaty we must be willing to compromise and modify at least some of our preferred negotiating positions. We cannot expect to reach agreements with any country if our demand is and remains that they sign our model treaty without change on the dotted line.

Second, in the proposed U.K. treaty this particular provision of our model was modified in two important ways—the time threshold for exclusion from the definition of permanent establishment was reduced from 24 to 12 months and the specific exclusion deleted coverage of "an installation or drilling rig or ship used for the exploration or development of natural resources."

Third, we note that the deletion of a reference to drilling rigs, etc. was prompted during the original negotiations of the proposed treaty in 1975 because the United Kingdom insisted on their right to tax these activities without any

limitation. The British view that they may tax under the proposed treaty even without this protocol seems clear. Moreover, since the United States under its statutory tax law would, in general, subject to U.S. tax the income derived by a foreign person from exploration or exploitation connected activities carried on in the U.S. (even if those activities were of very short duration). It is very difficult to argue that the United Kingdom should not have a similar right to tax.

Question 2. Do any tax treaties of the U.S. specifically name a single industry or activity for less favorable treatment in the manner that Article VI of the Third Protocol of the U.S.–U.K. Tax Treaty does for offshore exploration and development of natural resources?

Answer. The question assumes a conclusion which is not warranted. Neither Article VI of the Protocol, nor any other provision of the proposed treaty, singles out any taxpayer for less favorable tax treatment than they would have if there were no treaty at all. In general, tax treaties only benefit taxpayers. It is true that any particular treaty may benefit some more than others, but this necessarily follows from the nature of a negotiated agreement between two countries.

Generally, our tax treaties are replete with instances where particular industries, activities or types of income receive different measures of benefit. Looking to the U.S. model, for example, one discovers that the income of a resident of the United States from most business activities which are conducted through any fixed place of business in the other country may be taxed in the other country without any limitation. (Articles 5 and 7). Under Article 8, however, income of a resident of the United States from the operation of ships or aircraft in international traffic would be exempt from tax in the other country. United States Government employees are exempt from tax on their salaries in the other country (Article 19), while U.S. citizen employees of private employers may be taxed in the other country on their income from services there unless they are present in the other country for less than 183 days and other conditions are met (Article 15). Still different rules and different levels of benefits apply to U.S. citizens rendering independent personal services (Article 14) and those who are entertainers and athletes (Article 17). United States residents would be permitted to receive interest and royalties from the other country exempt from tax (Articles 11 and 12) but would receive dividends subject to tax of up to 15 percent (Article 10).

Question 3. Does the Department of Treasury expect what appears to me to be discriminatory treatment of offshore exploration and development activities to be part of other future treaty negotiations?

Answer. In future treaty negotiations, the Treasury will continue to seek the agreement of other countries to those provisions of our model income tax treaty which provide the greatest benefits to United States taxpayers. We cannot, however, realistically expect that each of our taxpayers will under any negotiated agreement obtain the same level of benefits as every other U.S. taxpayer.

The provision in the Third Protocol which permits both the United States and the United Kingdom to tax exploration and exploitation connected activities is, in our view, a reasonable one which conforms to our domestic tax law. As such, we remain prepared to consider its inclusion in future treaties where it is strongly requested by the other country as a condition for agreement to a treaty and where such a treaty is generally favorable to the United States. It must be remembered that this provision at worst only preserves a taxing right which the other country has without a treaty.

Question 4. Why was this industry singled out? Why was it not consulted before the announcement of agreement with the British? What economic impact studies were made to ascertain the effect of our country's capability to compete in the world market if this provision is adopted?

Answer. We are surprised at the assertion that the oil drilling companies were unaware of either the substance of the question or the specific terms of the protocol provision prior to the signing of the Third Protocol on March 15, 1979.

The drilling industry was clearly aware of the precise terms of the protocol provision at least one month prior to the signing of the Protocol on March 15, 1979. On February 16, 1979, Mr. Arnold W. Bramlett, Chairman of the Accounting and Taxation Committee of the International Association of Drilling Contractors (IADC), wrote to the International Tax Counsel, Mr. H. David Rosenbloom, expressing general concern over the provision. Subsequently, there were telephone conversations between Mr. Rosenbloom and Mr. Bramlett in which the Treasury sought specific information as to the nature of the activities and the harm which was alleged would occur. These requests were confirmed in a

letter from Mr. Rosenbloom to Mr. Bramlett on March 5, 1979, still 10 days before the protocol was signed. To date, the Treasury has not received from the IADC, or any of its members, specific information detailing any specific adverse effects of the protocol provision.

More surprising yet is that the drilling companies did not raise any objections either when hearings were held on the proposed treaty in July 1977, or before the treaty was approved in June 1978. They surely were aware of the possibility that the United Kingdom could tax their activities under the proposed treaty. This awareness is evidenced in a letter to the Treasury's International Tax Council dated October 17, 1975 from the law firm of Miller & Chevalier on behalf of its client, Santa Fe International Corporation—the very company for which Mr. Bramlett of the IADC works.

While not directly addressing the basic question of British taxation, the letter and accompanying memorandum provide ample evidence of a concern that without specific treaty language the drilling activities of Santa Fe could be taxed in the United Kingdom. Since the proposed treaty as approved by the Senate does not contain such specific language, one would think concern should have arisen much earlier.

The effect of this provision in the protocol on our country's capability to compete in world markets is judged to be small if indeed there is any impact at all. The provision in large, if not full measure represents merely a Treasury-to-Treasury transfer of revenue which should not materially impact U.S. taxpayers.

Under this provision, the income from these exploration or exploitation connected activities in the United Kingdom could be taxed by the United Kingdom. Under both the proposed treaty and our tax law, a United States company subject to this United Kingdom tax would be entitled to claim a foreign tax credit against its U.S. tax liability for the U.K. tax which may be imposed. There should be no double taxation in these circumstances. Tax on the income is paid only once, to the U.K. treasury. While it is true that the statutory corporate tax rate in the U.K. is higher than that in the U.S.—52 percent vs. 46 percent, it should be noted that at most there is only a potential excess foreign tax credit of 6 percent. But even this potential excess credit is mitigated further by other factors. By virtue of a variety of provisions of U.K. tax law, the U.K. effective tax rate may well be less than 52 percent and our overall foreign tax credit limitation would permit the U.S. company to offset any excess foreign tax credit on this income against the U.S. tax liability on any other lower-tax income from other foreign countries which the U.S. company may have. On balance, we do not believe this provision will adversely affect U.S. taxpayers in any material way.

Finally, it should be reiterated that we have not received any hard evidence from any company of specific harm. Indeed, our impression is that the concern expressed over this provision is not an industry-wide one, but rather that of only a few companies.

Question 5. Are drilling rigs owned by American companies which are temporarily operating in the U.K. waters now taxed by the U.S. or some taxing authority?

Answer. We cannot answer this question. We have repeatedly asked that the drilling companies concerned over this provision provide us with specific information detailing the precise nature of their activites and the adverse tax effects they would suffer. We have never been provided with this information.

Question 6. Have you measured the degree of involvement that U.K. companies currently have on the American Outer Continental Shelf to determine the relative benefit which this country could expect to derive from the enactment of this provision?

Answer. We do not know the degree of involvement of U.K. companies on the U.S. Continental shelf. It is important to recognize, however, that in any tax treaty it is not possible to weigh relative benefits on a provision-by-provision basis. Tax treaties, by their very nature deal with a wide variety of economic transactions and income flows. The benefitted transactions or income dealt with under one provision of a treaty may favor one country and those benefitted under another provision may favor the other country. Thus, in assessing the balance of a tax treaty it is necessary to look at all the effects and all the provisions in the aggregate. In this context, the proposed treaty taken as a whole provides many substantial benefits to U.S. taxpayers, principal among them is the British government's refund to U.S. taxpayers of a portion of the British Advance Corporation Tax. This amounts to a retroactive refund of over $500 million through 1979 and $100 million a year thereafter.

Senator HELMS. I am pleased that the committee today will hear from representatives of the International Association of Drilling Contractors at these hearings because I feel they can shed some light on an item which appears to me to be patently unfair and which needs some discussion in this committee.

I have some prepared remarks on this subject, but because of the time restrictions on us this morning, I will not read them, but would ask that they be included in the record at this point, as if read.

[Senator Helms' prepared statement follows:]

PREPARED STATEMENT OF SENATOR JESSE HELMS

Mr. Chairman: I am pleased that the Committee will today hear from representatives of the International Association of Drilling Contractors today at these hearings, because I feel they can shed some light on an item which appears to me to be patently unfair and which needs some discussion in the committee.

The offshore drilling industry and related construction activities appear to have been singled out among all other segments of American business for what seems to be highly unequitable and discriminatory treatment in the third protocol. This industry, I am told, was given no prior notice that this action was contemplated before it was "negotiated" away. The Department of the Treasury, it appears, took it upon itself to include this provision without investigating its impact on the U.S. offshore drilling industry.

Overall the United States is the clear leader in the offshore drilling and construction business connected with oil and gas exploration. To penalize this industry, which brings about a positive balance of trade, makes no sense whatsoever, especially in light of the increasing competition they are experiencing in foreign countries.

The discriminatory provisions are contained in article VI of the Third Protocol, which creates a special definition for the offshore drilling and construction industry that places them under U.K. tax jurisdiction as if they were permanent residents whenever activity is present for 30 days. All onshore and certain offshore construction industries have a one-year period in which to complete projects of a temporary nature before becoming subject to U.K. taxation. Also, the tradition exemption made for vessels is arbitrary removed with respect to ships employed in drilling and other construction operations.

There is no rational justification for this adverse treatment. We provide a minimum of two years as a reasonable period in our country's own model tax treaty, I am informed. Most countries recognize that activity of less than one year is temporary and not subject to the host country's tax laws.

I am told that these drilling contractors are not avoiding U.S. taxes during the time they are temporarily engaged in activity in a host country. But the nature of the drilling business moves them from place to place and from country to country. The extremely short 30-day definition would effectively bring them under immediate taxation since as a general rule they cannot drill a well in that limited length of time. Additionally, they will be taxed overall at abnormaly high rates.

Other countries around the world will want the same provision in treaties with the U.S. In fact, the Norwegian treaty has it already in draft form. If this is allowed to stand in the protocol, they have everything to gain and little to lose, since other countries do not have the degree of involvement in offshore drilling activities that Americans have.

I am persuaded that this committee should not report out the Third Protocol at this time and we should instruct the Department of Treasury to meet with the U.K. to bring this article into conformity with the provisions contained elsewhere in the protocol for other construction activities and vessels.

Moreover, we should instruct the Department of Treasury that this type of discriminatory provision must be resisted in the strongest possible manner from becoming part of any other tax treaty of the United States.

Mr. Chairman, the total dollars involved in respect to the overall treaty is very small, I am sure, but the effect on this one industry is significant. We should not put an unfair burden upon this single element of U.S. industry. The offshore drilling business is made up of separate service companies. We are not talking

about the oil companies. To place a heavy economic burden on these companies which do so much to help discover and develop the energy resources of the countries around the world is inappropriate in light of today's energy demands.

Senator HELMS. Our next witness this morning is Mr. Irving Davis of the Accounting and Tax Committee of the International Association of Drilling Contractors.

Mr. Davis, we are pleased to have you with us this morning. Would you please introduce your colleagues to the committee.

STATEMENT OF IRVING DAVIS, MEMBER, ACCOUNTING AND TAX COMMITTEE, INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS, HOUSTON, TEXAS; ACCOMPANIED BY: THOMAS ANDERSEN AND JON BEDNERIK, INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS

Mr. DAVIS. Thank you, Mr. Chairman. My name is Irving Davis and I am a member of the IADC Accounting and Tax Committee. I am accompanied by Mr. Jon Bednerik, on my right, and Mr. Tom Andersen, on my left.

IADC OBJECTION TO ARTICLE 6 OF THIRD PROTOCOL

We are here today to object to the language in article VI of the third protocol which specifically picks out the offshore drilling and construction industry to change the norm for the description of "permanent establishment" and which also removes the standard shipping exclusion for U.S. registered vessels as it applies to drilling firms.

We also object not only to the language, but to the way in which the Article was negotiated, that is, without an opportunity on the part of the industry to have any input whatsoever. We found out about the Article approximately 3 days prior to the protocol being signed.

CHANGE STANDARD 12-MONTH PROVISION TO 30 DAYS

What the Article does is change the standard 12-month provision for a "permanent establishment" to 30 days for drilling contractors on offshore construction activities. We cannot understand the distinction that is made between these taxable activities and other types of construction activities. Also, these provisions are at complete variance with any other treaty to which the United States is a part, of which we are aware. For the most part, the permanent establishment provisions are 12 months. We know of one that is 24 months, and I believe the Model Treaty calls for 24 months.

IADC SEEKING PARITY WITH OTHER INDUSTRIES

In the chairman's opening statement, he said that we objected to the United States-United Kingdom protocol which amends the proposed treaty to make it clear that the United Kingdom will not be barred under the treaty from taxing the income. What we are really seeking here is not to bar anybody from taxing us; we are seeking parity with other industries that still have the 12-month permanent establishment provision.

Also, in Mr. Lubick's statement, he says that the absence of such a rule could lead to international tax avoidance because of the mobile nature of the activities in question. This is far from the truth. These are all U.S. companies about which we are talking. They are all U.S. vessels. The United States does tax every bit of this income.

We also have read the explanation of the third protocol prepared by the joint committee. This explanation does treat the effects of the Protocol on the drilling contractor in the offshore construction activities and does it fairly. There are a few things on which it does not focus, however, which I would like to mention.

SHIPPING IN INTERNATIONAL WATERS

First of all, the explanation talks about shipping in international waters. The First Protocol to the treaty provides for a shipping exclusion just if it is a U.S. registered vessel, regardless of whether it works entirely within the United Kingdom or not. So, we feel that we still should come under this particular exclusion.

PROBLEMS OF ALLOCATION OF EXPENSES

The second point that it does not really approach concerns the nomadic nature of these units. They move from place to place. They are not working all the time. There are periods of idle time. There are periods when they are in the shipyards for repair, modification, and inspection. These do not take place necessarily in the same areas in which they have been working.

There is a problem, then, of allocation of expenses. Which jurisdiction will accept the idle time expenses? Which jurisdiction will accept the shipyard expenses for repair and modification? Which jurisdiction will accept the expenses of labor and overhead while the unit is idle? If it has been working in the United Kingdom and it is tied up in Holland, which is very likely, who will accept these expenses under their tax jurisdiction?

We had an instance previously of the British not accepting mobilization costs for bringing a unit into the North Sea. This is merely one example of what can happen under the proposed third protocol.

That concludes my remarks, Mr. Chairman.

[Mr. Davis' prepared statement follows:]

PREPARED STATEMENT OF IRVING DAVIS

The International Association of Drilling Contractors (IADC) is an industry trade group representing over 1,100 member companies engaged in or connected with the contract drilling of oil and gas wells for the petroleum industry. The IADC urges the United States Senate to reserve Article VI of the Third Protocol to the U.S.-U.K. Tax Treaty because this Article is discriminatory to the U.S. drilling industry and creates a dangerous precedent for future tax treaties.

Article VI creates a special definition of "permanent establishment in the host country" whereby after a period of only 30 days (rather than 12 months) any offshore drilling rig or drilling vessel which operates on the continental shelf of the U.K. is subject to U.K. taxation. This provision singling out the offshore drilling industry is at substantial variance with present treatment of such activities contained in every other existing tax treaty to which the United States is a party. It is also at substantial variance with the U.S. Model Tax Treaty regarding such operations which provides for two years as the period for defining a "permanent establishment" for exploration or development of natural resources.

In addition, all U.S. tax treaties provide a normal exemption from taxation in the host country for U.S. flag vessels. The Treaty keeps this normal exemption intact except that, should Article VI be ratified, this normal exemption would specifically exclude vessels engaged in drilling operations.

Article VI, if ratified, would impose a greater tax burden on the U.S. drilling industry due to higher income tax rates in the U.K. (52 percent vs. 46 percent in the U.S.) and would create excess foreign tax credits which may not be offset against U.S. tax liability. This provision would also prevent or delay full utilization of a significant investment incentive endorsed by the Congress, i.e., the Investment Tax Credit.

Article VI, if ratified, could place the U.S. offshore drilling industry at a competitive disadvantage with drilling companies based in other countries. This would take place if the U.K. does not have a similar set of provisions in its treaties with such other countries. It should also be pointed out that this Article VI, if ratified, would create a significant shift of tax revenues from the U.S. Treasury to the U.K. taxing authority.

In summary, the inclusion of this Article VI involves a substantial change in the taxation of a particular industry after the basic provisions of the treaty have been accepted by both governments without any mention of any change in the application of the 12 month period rule for defining "permanent establishment." The proposed Article VI deviates from the concept of permanency generally associated with the nexus for taxation. It does not reflect the nomadic nature of the offshore drilling industry. Drilling contractors provide highly mobile equipment and services in response to contracts in ever-changing locations where oil and gas exploration is being carried out. In this respect the drilling industry is truly international and is similar to traditional merchant shipping and should be treated as such. This provision would also establish a dangerous precedent for treaties between the U.S. and other oil producing nations such as Norway, Nigeria, Australia, France, the Netherlands, and many others. These and other countries who are not importers of offshore services will surely insist on similar provisions thus compounding the penalizing effect on this U.S. industry.

For the above reasons the discriminatory and burdensome Article VI of the Third Protocol should be reserved by the U.S. Senate during its deliberations and ratification.

Senator HELMS. Thank you very much, Mr. Davis.

I'm afraid that I must leave this hearing now, so this committee will stand in recess upon the call of the Chair.

[A brief recess was taken.]

The CHAIRMAN [presiding]. Our next witness this morning is Mr. Joseph H. Guttentag of Arnold & Porter.

Mr. Guttentag, do you have a written statement that you wish to submit for the record?

Mr. GUTTENTAG. Yes, Mr. Chairman, I do.

The CHAIRMAN. Would you briefly summarize your position for the committee.

STATEMENT OF JOSEPH H. GUTTENTAG, COUNSEL, ARNOLD & PORTER, WASHINGTON, D.C., FORMERLY, INTERNATIONAL TAX COUNSEL AT THE DEPARTMENT OF THE TREASURY

Mr. GUTTENTAG. Thank you, Mr. Chairman, I will summarize and be brief.

SUPPORT RATIFICATION OF ALL SIX TREATIES

My name is Joseph Guttentag. I am an attorney with Arnold & Porter. While I do have some clients who are interested in this treaty, I am appearing here on my own behalf to support the ratification of all six of the treaties that are before you.

The tax conventions are a long time in gestation. At least one of the conventions was being considered when I was with the Treasury over 10 years ago.

There has been a lot of work done on these conventions. But still, all of the issues raised, all of the tax problems between the United States and the countries involved, have not been solved. Yet, the conventions do reflect the balance of the views of the United States and the foreign negotiators, and they have received the support of the Treasury, the State Department, and the White House.

Mr. Chairman, there is no way that these conventions can serve to increase the taxes of any of the taxpayers affected, either the foreign or U.S. taxes.

While the United States strives to reduce or eliminate the incidence of foreign taxation, foreign taxes will not be increased above the rates that would apply without the convention.

These concepts should be kept in mind when we listen to any petitions for further changes or delays on the ground that a convention does not provide appropriate benefits in a particular case or to a particular industry.

The conventions are balanced. They are technically appropriate. They are necessary and they are needed now.

I thank you for your unusually quick consideration of these conventions and I urge your prompt recommendation for the Senate's advice and consent to the ratification without any reservations.

Thank you.

[Mr. Guttentag's prepared statement follows:]

PREPARED STATEMENT OF JOSEPH H. GUTTENTAG

My name is Joseph Guttentag. I am an attorney with the Washington, D.C. firm of Arnold & Porter. My work is primarily in the field of international taxation.

I appear before you this morning to urge that you give your prompt advice and consent to the ratification of each of the six tax conventions presently under consideration.

While some of my clients have an interest in one or more of these conventions, I appear here on my own behalf as a tax practitioner and citizen concerned with these proceedings.

I wish to advise you of the substantial interest and concern of a wide spectrum of Americans and American companies in these proceedings. These conventions will benefit:

Factory workers and their employers engaged in the manufacture of goods to be exported and sold overseas without being burdened by foreign taxes or filing requirements.

U.S. executives and professionals stationed temporarily overseas who need not now be concerned that, if they should die suddenly, their families would be subjected to foreign death taxes, which could be confiscatory, particularly since their wills and estate plans are drafted to comply with American law.

Businessmen, artists, students, retirees, who can travel freely, knowing that they will be exempt from foreign taxes or that appropriate relief will be afforded to avoid double taxation.

The trend is to greater sophistication and complexity of U.S. and foreign tax laws, more active enforcement, increased attention to taxation of international transactions, and extra-territorial extension of tax laws. These factors have made tax conventions designed to avoid double taxation and prevent evasion of taxes of greater significance.

Tax conventions are often a long time in gestation. At least one of the conventions before you today was under negotiation when I served with the Treasury Department over a decade ago. The package of conventions now being considered represents about ten years' work of the Treasury staff assigned to these matters.

The Treasury is cognizant of these problems. In order to expedite the negotiation process and provide some degree of uniformity, the OECD countries, including the United States, have agreed upon models to be used at least as

starting points in the negotiations. Commentaries on the models reveal areas of disagreement and reservations by the several countries to assist and to expedite the tax convention process.

I assure you, of my own personal knowledge, that these conventions represent the best thinking and negotiating skill of highly trained, hard working Treasury Department lawyers and economists—as well as, of course, of their counterparts in foreign governments. The other governments are appropriately concerned and desirous that the work of perhaps many years receive prompt and appropriate consideration by this Committee and the Senate.

Despite this work and devotion to the issues raised, all tax problems arising between the United States and the countries involved are not necessarily solved. The tax conventions reflect a balance of the views of the United States and foreign negotiators, and the completed packages have received the approval of Treasury, State and the White House. Many of the provisions are of benefit to both United States and foreign taxpayers by preventing or limiting double taxation of the same income. Other provisions benefit the fiscs of both countries by providing means of enforcing the tax laws through collection assistance and information exchange.

All in all, the conventions strive to represent a balancing of the interests of the governments involved and all of their taxpayers.

The conventions are not identical, as they must deal with different tax and economic systems. However, there are certain basic internationally accepted rules of taxation, and it is in the interest of the United States to adhere to these basic principles.

United States taxpayers may find a benefit in one convention not found in another. This does not mean the Treasury was unmindful of the problem or neglectful. It does mean a balance was struck in a different, but no less appropriate, fashion.

Even in those cases in which a particular problem is not fully dealt with, the conventions provide a means for consultation and a forum for resolution of remaining issues. Serious problems which remain, or new issues which arise by changes in the law or otherwise, may always be resolved by subsequent protocol.

The tax convention can only help, not hurt, the tax positions of the American taxpayer. In no case can the conventions serve to increase the United States taxes imposed on Americans, who can always choose to be taxed under the Internal Revenue Code without regard for the convention. Similarly, while the U.S. strives appropriately to reduce or eliminate the incidence of foreign taxation, foreign taxes will not be increased as a result of these conventions above the rates that would apply without a convention. These concepts, as well as the entire negotiation process, should be kept in mind in listening to any petitions for further changes or delays on the grounds that a convention does not provide appropriate benefits in a particular case, or to a particular industry.

There are obviously many agreements which come before you, in this room, of greater importance to the United States. I appear here, in part at least, to assure you that the absence of a crowded hearing room or lack of constituent mail on these agreements does not mean they are unimportant.

These tax agreements are usually denominated as "conventions" in international legal parlance, indicating that they do not rise to the significance and political importance to be denominated treaties. They should be considered as commercial agreements and, as such, apolitical. We should not let adverse political relations, often temporary, prevent us from establishing a sound tax basis for trade and investment. If political conditions warrant, we can restrict commercial activities temporarily through other appropriate legislative or executive action.

The conventions are balanced, they are technically appropriate, they are necessary, and they are needed now. I thank you for your unusually quick consideration of these conventions, and I urge your prompt recommendation for the Senate's advice and consent to their ratification.

FAMILIARITY WITH PROVISIONS OF SIX TREATIES

The CHAIRMAN. Thank you very much, Mr. Guttentag, for the brevity of your statement. I appreciate it at this late hour.

Are you familiar with the provisions of all six of these treaties?

Mr. GUTTENTAG. In general I am, Mr. Chairman, though I am more familiar with some than I am with others.

The CHAIRMAN. Are you familiar with the history of the United States-United Kingdom treaty last year when the Senate attached a reservation, which I had offered, dealing with the attempted effort to restrict the right of State governments in this country to choose the mode by which they would tax foreign owned corporations?

Mr. GUTTENTAG. I am, Mr. Chairman.

The CHAIRMAN. It is my understanding that none of these treaties presently pending contains any comparable provision to that which was stricken from the United States-United Kingdom Income Tax Treaty last year.

Mr. GUTTENTAG. That is correct, Mr. Chairman.

The CHAIRMAN. I think that question should be carefully checked by the staff in reviewing the provisions of each treaty. We do not want to be faced with that problem again when we take the treaties to the floor of the Senate.

Mr. Guttentag, thank you very much for your presentation.

Mr. GUTTENTAG. Thank you, Mr. Chairman.

The CHAIRMAN. Our next witness is Mr. Bruce Walker, chief counsel of the California Franchise Tax Board.

Mr. Walker, welcome to the committee today. Would you please introduce your colleague to the committee.

STATEMENT OF BRUCE WALKER, CHIEF COUNSEL, CALIFORNIA FRANCHISE TAX BOARD, SACRAMENTO, CALIF., ACCOMPANIED BY JONATHAN ROWE, DEPUTY EXECUTIVE DIRECTOR, MULTISTATE TAX COMMISSION, BOULDER, COLO.

Mr. WALKER. Yes, Mr. Chairman. With me is Jonathan Rowe, who is with the Multistate Tax Commission.

Senator, I did not intend to appear here today, but we understood that Senator Mathias had requested permission to appear and talk about his S. 983, so that is really the reason for my appearance.

CALIFORNIA'S USE OF UNITARY TAX CONCEPT

When one talks about the unitary tax concept, California is the principal villain in the picture according to our multinational friends. We do understand that there is a problem in this area and we do not minimize it. However, I think other people have grossly exaggerated the type of problem that is involved.

We have been taxing multinational organizations in this manner, using the unitary concept, for a great many years. Still when you look at California's economy, you find that every U.S. multinational of any size is doing business in California. They continue to make investments in California. There are also a tremendous number of foreign based multinationals in California.

Every foreign bank of which you have ever heard is present in California.

We believe that the problems in connection with the unitary concept applied by a State have been grossly exaggerated, and we do not think this is the time for Federal legislation.

One of the reasons for that is that there is a General Accounting Office study which has been going on in this area. Part of their charge, as I understand it, in this study is to compare the California approach to this matter with that of the Treasury and to make some kind of evaluation as to which is the better.

PRESIDENT'S PROGRAM RECOMMENDED ELIMINATION OF DEFERRAL OF FOREIGN INCOME

Also I might note that the President's program, which came out in 1978, went a short way toward adopting the California approach in that it recommended that the deferral of foreign income be eliminated.

There are a great many problems in Senator Mathias' bill. We testified against it.

This is just about all I have to say.

Senator, I would like your permission to submit a statement in writing because I had not had time to prepare one for this appearance today.

The CHAIRMAN. Thank you. I was going to suggest that you do submit such a statement. But because there is some urgency in bringing these treaties to the floor for ratification, please be prompt in sending us your statement.

Mr. WALKER. We will do it at once, Senator.

[As of the date of publication, the information referred to had not been received.]

The CHAIRMAN. Thank you for your appearance here today.

Our final witness of the morning is Mr. Samuel J. Lanahan of Wilmer, Cutler & Pickering, Washington, D.C.

Mr. Lanahan, I wonder if you would also oblige us by submitting your written statement in full for the record and summarizing it at this time.

STATEMENT OF SAMUEL J. LANAHAN, WILMER, CUTLER & PICKERING, WASHINGTON, D.C.

Mr. LANAHAN. Thank you very much, Mr. Chairman. I would be glad to do so.

RATIFICATION OF PROTOCOL OF UNITED STATES-FRANCE INCOME TAX TREATY

I did not plan to go over the whole statement. I am here to urge speedy ratification of the protocol to the United States-French income tax treaty. I notice that you said in your opening remarks, Mr. Chairman, that if it is not ratified by the end of 1979, there will be double taxation on U.S. citizens residing in France.

I agree with that and wish to point out in addition that these people are being disadvantaged at the present time because they are required to pay declarations of estimated tax. The next one is due June 15. The prudent course of action to avoid penalties would be to assume that the protocol would not be ratified in 1979.

In addition, I understand that U.S. residents leaving France, in order to get clearance from Customs and foreign exchange controls, have to file tax returns. The tax is computed on the basis of French

tax applying to their worldwide income. So there are people now who are being economically disadvantaged by the delay in ratification of the protocol.

I urge your committee, sir, to take prompt action.

[Mr. Lanahan's prepared statement follows:]

PREPARED STATEMENT OF SAMUEL J. LANAHAN

My name is Samuel J. Lanahan. I am a member of the Washington, D.C. law firm of Wilmer, Cutler & Pickering. I am testifying on behalf of a number of U.S. citizens residing in France and a number of organizations formed by U.S. citizens in France to further their social and business interests. The organizations are:

Association of American Wives of Europeans.
Democratic Party Committee in France.
Republican Party Committee in France.
American Hospital.
American Club of the Riviera.
American Women's Group in Paris.
The American Legion (France).
The Veterans of Foreign Wars (France).
Association of Americans Resident Overseas.
American Chamber of Commerce in France.
The American Club of Paris.

I am here to testify in favor of early ratification of the Protocol to the United States-French Income Tax Convention.

As you know, the Protocol is designed to avoid the potential double taxation of U.S. citizens residing in France that can result from a 1976 change in the French income tax laws effective January 1, 1979, which for the first time subjects such U.S. citizens to French income tax on their world-wide income.

The rules of the Protocol which seek to eliminate this double taxation are fully explained by the Staff of the Joint Committee on Taxation in its technical study of the Protocol. Instead of repeating this material, I want to remind this Committee of the pressing need for early and favorable action on this matter. The delay in ratification results in an actual out of pocket cost to U.S. citizens residing in France. For example, they have the problem of filing declarations of U.S. estimated tax for 1979 and making payments thereon which will properly reflect their U.S. income tax liability. In order to avoid possible penalties, it is prudent that the amount of these payments be based on the assumption that the Protocol will not be ratified in time for its application to the payments made in 1979. The next estimated tax payment is due on June 15th.

In addition, U.S. citizens who reside in France and who are leaving in 1979 must file French tax returns and pay the tax before obtaining necessary customs and exchange control clearances. I am advised that it is likely that they will have to do so on the basis of their world-wide income and without the benefit of the Protocol so long as it is not in force.

For these U.S. citizens, there is a real economic penalty in delaying ratification.

It has been nearly three years since the change in the French tax law. During this time, U.S. citizens residing in France have lived in uncertainty concerning their tax status. It has made individual income tax planning difficult. It has also been difficult for U.S. companies to move U.S. employees into their French operations. It has generally been considered desirable in transferring employees to foreign countries to arrange their compensation in such a way that the impact of taxes is a neutral factor in the employee's decision whether or not to accept a foreign job. The present situation makes it difficult to compute how this tax neutrality can be achieved.

Finally, ratification of the Protocol is of vital concern to U.S. citizens who live in France on fixed, retirement incomes. Under the Protocol, these individuals will be exempt from French income tax on this income to the extent attributable to service performed while their principal place of employment was in the U.S. Clearly, these individuals are least able to survive any double taxation that may occur if the Protocol is not ratified.

Your prompt ratification of the Protocol is respectfully urged.

The CHAIRMAN. Thank you very much, Mr. Lanahan, for your testimony. I want to assure you that it is our present intention to do just that.

We have certain written questions that have been prepared by staff for our witnesses and we would hope that the witnesses to whom they are directed would respond to them in writing within the next 48 hours.

[Additional questions and answers follow:]

DEPARTMENT OF THE TREASURY,
Washington, D.C., June 8, 1979.

HON. FRANK CHURCH,
Chairman, Committee on Foreign Relations,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: To follow-up my testimony at the June 6 hearings concerning the six tax conventions or protocols involving the United Kingdom, France, Hungary and Korea, I want to assure you that Article I of the Third Protocol of the proposed US-UK Income Tax Treaty gives full effect to the Senate's reservation on Article 9(4) of that treaty. Let me also assure you that there is no similar state tax issue in any of the other five treaties which were considered by the Committee yesterday.

Again let me emphasize our view that each of these treaties is important to the United States and that their prompt approval is desirable.

I am also enclosing answers to the written questions submitted to me by your staff at the hearings as well as copies of my answers to questions from Senator Helms and Senator Javits.

Sincerely,

DONALD C. LUBICK,
Assistant Secretary for Tax Policy.

Enclosures.

DONALD C. LUBICK'S RESPONSES TO ADDITIONAL QUESTIONS FOR THE RECORD

Question 1. On page three of your testimony, you mentioned that the public was able to make presentations to the Treasury concerning particular private sector concerns in the area of international taxation, could you explain how the notice of such public meetings is made, what the participation level has been and any changes in tax treaties or negotiations that have been affected by this public participation?

Answer. The public meetings, referred to in the testimony, are announced by Treasury Press Releases and notices in the Federal Register. These announcements are reported in publications which are widely read in the international tax community. Public participation in these meetings varies, depending on the degree of interest in the particular country being discussed. The meeting to discuss the Canadian treaty was attended by well in excess of 100 individuals; a recent meeting to discuss a proposed treaty with Norway was attended by about 20 people. All of the reports we have received from the public regarding these meetings have been favorable.

It is difficult to point to particular changes in treaties under negotiations as a result of these meetings. In most cases, there has not yet been a further round of negotiations following the meeting. The meetings have clearly served to sharpen the negotiator's awareness and understanding of some of the complex issues involved.

Question 2. The group of six tax treaties or protocols the Committee is conducting hearings on today, will they result in a net loss or gain for the U.S. from tax revenues. If a loss, how much and why; if a gain, how much and why?

Answer. In general, these treaties and protocols tend to balance out revenue losses and gains, leaving the overall revenue effect roughly neutral. For example, where the treaty partner is required to reduce or eliminate its tax on U.S. taxpayers, this results in a reduction in the U.S. foreign tax credit and an increase in U.S. revenue. These increases are roughly offset by reductions in U.S. revenues resulting from reductions in U.S. tax on taxpayers resident in the other country.

In most cases, data on international flows and transactions are not available in sufficient detail to permit precise estimation of the revenue effects of particular treaty provisions.

Question 3. Please describe the personnel from the Department of the Treasury and other agencies of the U.S. Government involved in negotiating tax treaties or protocols. Please detail the prospective relationships between the IRS, Department of the Treasury and the Department of State.

Answer. The Office of Assistant Secretary for Tax Policy in the Treasury has the principal responsibility for the negotiation of tax treaties. The actual negotiations are normally conducted by members of the Office of International Tax Affairs, which combines the Office of International Tax Counsel (Attorneys) and the International Tax Staff of the Office of Tax Analysis (Economists). The delegations are headed either by the Assistant Secretary for Tax Policy or by a senior member of the Office of International Tax Affairs.

The Internal Revenue Service is often represented on delegations. The nature and extent of this representation depends on the specific issues that are likely to arise. For example, if there are problems regarding the exchange of information, representatives of the IRS Office of International Operations, which is responsible for these exchanges, will participate in the discussions. In many cases, when negotiations are held abroad, the Revenue Service Representative assigned to that country will participate.

The State Department is invited to participate in all discussions. Country desk officers will sometimes attend a part or all of the discussions held in Washington. When negotiations are held abroad, the economic or commercial officers in the U.S. Embassy frequently participate. The State Department generally handles correspondence between the U.S. and foreign negotiators and is often called upon to follow up with representatives of the other country on issues which arise in the negotiations.

There is close coordination between Treasury, IRS and the State Department throughout the negotiating process. The State Department advises the Treasury on political issues and IRS advises on administrative matters. The State Department is responsible for the arrangements for signing treaties and transmittal to the Senate.

Question 4. The U.S. Treasury, in 1977, finalized a "model convention" for international tax treaties, could you please explain the status of this model and in particular, any changes that have been made to it?

Answer. For many years, the Treasury had used an informal "model" as a basis for negotiations. This model evolved and changed as the negotiators gained experienced with it. In 1976 a decision was made to publish the U.S. model. Following the 1977 publication of the revised OECD Model Convention, the Treasury revised its model to conform it to the OECD Model, where possible, and the revised model was published in May of 1977.

The model is sent to potential treaty partners prior to the commencement of negotiations, and it normally serves as the discussion draft during the first round of negotiations. Many changes are made in the model during negotiations to reflect particular problems which arise in attempting to mesh two tax systems. Changes may be made to reflect the needs of the other country. For example, where negotiations are with a developing country, many of the model provisions (designed for treaties between two developed countries) are inappropriate. The U.S. negotiators are generally quite flexible in modifying the model for treaties with developing countries. These changes occur most frequently in the provisions dealing with permanent establishments of the taxation of personal service income, in which cases a somewhat lesser degree of economic contact or penetration is required for the host country to be able to tax the income of a resident of the other country. Similarly, with the taxation of dividends, interest, and royalties, less of a reduction in withholding tax rates is generally required of developing countries. The U.S. interest in these cases is to avoid rates which are so high as to generate excess foreign tax credits for U.S. income recipients.

Question 5. In the third protocol proposed to the U.S.–U.K. Income Tax Treaty, the definition of permanent establishment has been changed. Please explain the basis of this change. Were the affected U.S. drilling companies contacted concerning the proposed change? If they were contacted, please give the details of when, by whom, and what resulted from such contact. Why was the permanent establishment definition selected as the item to be changed in the tax area?

Answer. In our discussions with the British subsequent to the Senate reservation on Article 9(4) of the proposed treaty, the United Kingdom specifically requested the inclusion in the protocol of a provision clarifying their taxing rights with respect to exploration and exploitation connected activities. This requested clarification was not unusual in light of the original negotiations in

1975 over the permanent establishment definition. In those negotiations, the United States agreed to delete from the twelve month permanent establishment exclusion contained in subparagraph (2)(f) of the proposed treaty any reference to "an installation or drilling rig or ship used for the exploration or development of natural resources" as a result of the British insistence that there be no limitation on their right to tax such activities. This deletion left the application of the permanent establishment definition to these activities somewhat uncertain, although as the United Kingdom authorities believe, a strong argument exists that these activities could be taxed even without the clarification of the new protocol.

We agreed to the inclusion of this provision in the Third Protocol because it was reasonable to expect the British to request some additional concession for the loss of the benefits of article 9(4); because the terms of the provision were reasonable in light of our own statutory tax policy (we would generally tax these kinds of activities conducted in the United States, even if they were of a shorter duration than 30 days); and because it could be viewed as little more than a clarification of a reasonable interpretation taken by the British of their taxing rights under the proposed treaty without the protocol provisions.

The drilling industry was clearly aware of the precise terms of the protocol provision at least one month prior to the signing of the Protocol on March 15, 1979. On February 16, 1979, Mr. Arnold W. Bramlett, Chairman of the Accounting and Taxation Committee of the International Association of Drilling Contractors (IADC), wrote to the International Tax Counsel, Mr. H. David Rosenbloom, expressing general concern over the provision. Subsequently, there were telephone conversations between Mr. Rosenbloom and Mr. Bramlett in which the Treasury sought specific information as to the nature of the activities and the harm which was alleged would occur. These requests were confirmed in a letter from Mr. Rosenbloom to Mr. Bramlett on March 5, 1979, still 10 days before the Protocol was signed. To date, the Treasury has not received from the IADC, or any of its members, specific information detailing any specific adverse effects of the protocol provision.

Question 6. The proposed protocol is drafted to allow American citizens and corporations to avoid double taxation, would you explain why France has decided to tax on the basis of worldwide income?

Answer. France has traditionally taxed its residents on their worldwide income with the one notable exception that residents who were not French citizens and who remained subject to tax on their worldwide income by the country of citizenship were taxed in France only on their French source income. In recent years this exception has been the object of increasing criticism. It put U.S. citizens living in France in a preferred position compared to other French residents. In the fall of 1976, a bill was introduced in the National Assembly to repeal this exception (Article 164–1 of the Code General des Impot) effective January 1, 1977. U.S. and French representatives met in November 1976 to consider how to avoid the double taxation under the new law. The effective date of the bill as enacted was delayed until January 1, 1979. In that interval, the Protocol was negotiated and signed.

Question 7. The proposed protocol has a special provision for the taxing of partnership profits. Could you give a few examples of how the income of a partnership will be designated as having been derived in France or the U.S.? In addition, would you specify the policy reason for attributing 50 percent of the partnership's income as being derived from France if the figure is in fact below 50 percent?

Answer. (a) A partnership of two partners who are U.S. citizens, one living in France and one in the United States, has $100,000 of income, $50,000 from France and $50,000 from the United States. Each partner's share is $50,000 of which $25,000 is French source and $25,000 U.S. source. Without the protocol, France would treat as French source the $25,000 of French income of the nonresident partner and the full $50,000 of income of the resident partner (because they view it as income for services in France). With the protocol, France will consider each partner to receive $25,000 of French and $25,000 of U.S. income and will tax accordingly.

(b) Same facts as above except that $80,000 of the partnership income is from the United States and $20,000 from France. Without the protocol, France would treat as French source $10,000 of income of the nonresident partner (one half of the income of the French office) and $50,000 (all) of the income of the resident partner. With the protocol, France will tax the nonresident partner on his $10,000 of French income and the resident partner on $25,000 (he has only

$10,000 from the French office but France is not required to exempt more than half his share of $50,000). The partnership may elect to treat the additional $15,000 of income of the resident partner taxed by France as of French source and claim a credit for the French tax to avoid double taxation.

(c) The 50 percent rule was adopted to ensure France that, in giving up its statutory right to tax all profits attributed to French resident partners, it was not creating an incentive for abuse. The French were concerned that partnerships would report little or no income from their French offices (i.e., at the partnership level) while the individuals residing in France received large amounts of income on which they would pay no French tax. It was agreed that if France would accept in principle that only income derived from France at the partnership level is of French source, they would not be required as a result to exempt more than half of the profit share of a French resident partner. The 50 percent rule was discussed in advance with some of the U.S. partners resident in France and they considered it acceptable.

Question 8. In the letter of transmittal to the President from the Secretary of State, the Secretary mentions that the proposed protocol was derived in large part from a U.S. model tax convention. Please explain the origin of the model convention and its applicability in the international tax area. How many times has it been used? With which countries? What have the results been?

Answer. The U.S. model income tax convention was developed to provide a uniform starting point for U.S. income tax treaty negotiations and to conform U.S. treaties as closely as possible to the model income tax convention of the O.E.C.D. (Organization for Economic Cooperation and Development), which had become widely known and used by other countries since its publication in 1963. A U.S. model was published in May 1976, and a slightly revised version in May 1977. A revised OECD model was published in January 1977 and the U.S. and OECD models now conform closely in most provisions. The U.S. model has been used in all treaty negotiations undertaken since early 1976. It was used in negotiating the treaties now if effect with Poland and Romania (and to a lesser extent that with the USSR which required significant departures) and with the treaties with Korea, the Philippines, Hungary, and the United Kingdom now before the Committee. It is also being used in ongoing negotiations with other countries including those with Argentina, Brazil, Denmark, Egypt, Israel, Italy, Jamaica, Malta and Spain.

Use of the model has permitted the negotiations to progress at a much faster rate than before. And its resemblance to the OECD model has generated interest on the part of developing countries, as many of them have become familiar with the OECD model.

Question 9. Would you please comment on the chances of reconciliation between the French and U.S. views regarding the possibility of France giving tax credits on dividends to U.S. direct investors and the French position that States of the U.S. should not tax U.S. profits of French subsidiaries by means of a formulary apportionment of their worldwide profits. Does the Department have a proposed schedule for attempting any reconciliation of these differences?

Answer. We will continue to raise the dividend tax credit issue with the French and to monitor the French position in other treaties. (France is committed to reopen the discussion of this issue as soon as feasible "and in any event if the avoir fiscal is extended in full or in part to direct investors of other countries.") U.S. and French tax authorities are in contact frequently, including at the twice yearly meetings of the Committee on Fiscal Affairs of the OECD, so there are ample opportunities to keep the issue alive.

The Treasury Department has been in touch with representatives of state tax authorities on possible approaches to the unitary tax issue. We will continue to work with them and with Congress to seek an acceptable solution, whether by legislation or treaty. We will not propose a treaty solution without assurances that it is acceptable.

QUESTIONS ON UNITED STATES-FRANCE ESTATE AND GIFT TAX TREATY

Question 10. The proposed Convention is an extension of the Foreign Investors Tax Act of 1966, could you please describe the benefits, as you see them, that the U.S. has derived from the 1966 Act as well as the first convention under that Act with the Netherlands?

Answer. The proposed Convention is not really an "extension" of the Foreign Investors Tax Act of 1966. It is a Convention which modifies the provisions of the

convention currently in force between two parties in order to harmonize the treaty arrangement with the provisions of the 1966 Act.

The primary objective of the 1966 Act was to remove or reduce barriers created by the tax system to the free flow of foreign capital into the United States. The estate tax provisions of the Act lowered the tax rate imposed upon the estates of foreigners who owned U.S. property at their death. The primary achievement of the statute was to lessen tax barriers to the inflow of foreign capital into the United States.

The primary achievement of the Netherlands Convention from the perspective of the United States was the agreement by the Netherlands to the special rules which deem a U.S. citizen a domiciliary of the U.S. if he is deemed domiciled in both countries at the time of his death, but if he has not lived in the Netherlands more than 7 of the 10 years ending with his death. This ensures that American citizens living in the Netherlands will not be subject to Netherlands estate tax unless they have formed an intent to stay in the Netherlands, or have lived there a long time. This is of substantial importance to U.S. companies doing business in the Netherlands, since it permits them to assign their executives to the Netherlands without the employees' becoming subject, simply by virtue of living in the Netherlands for a short time, to Netherlands estate taxes.

Question 11. A major feature of the proposed convention is the use of a five year time period that will be the basis for determining the domicile of a taxpayer. Could you explain the reason the five year time period was selected?

Answer. The five-year period is relevant only in cases where each State under its own law considers an individual to be its own domiciliary at the same time. The five-year period is irrelevant to the determination of domicile under domestic law, and comes into play only after such a determination has been made in each State. It also applies only if the person is a citizen of only one of the Contracting States.

The five-year period (or the 5-of-7 rule of Article 4(3) of the Convention) was the product of bargaining between the parties. The official U.S. position, reflected in the model treaty and the U.S.-Netherlands treaty, is that a person should have to live in a country other than that of his citizenship 7 of 10 years before his death to be subject to the new country's death taxes. The French position was that only the "tie-breaker" rules of Article 4(2) should be used for any case of "double domicile," regardless of the fact that the person was a citizen of only one Contracting State. The 5-of-7 rule represents a compromise between the two positions.

The 7-of-10 year rule of the model is based upon a balancing of concerns for determining which State should have the right to tax the lifetime accumulation of an individual. In general, the U.S. believes that the momentary circumstance of residence at death should not be controlling, particularly where a citizen of one country is residing abroad, and doing so only for a short time. The U.S. believes, however, that if a person lives in a country for a substantial period of time, at some point that country acquires a legitimate claim to tax the person's lifetime accumulation, even if the person is not a citizen of the country and does not intend to remain there forever.

Question 12. Would you detail the number of individuals affected by the proposed Convention and the revenue that will be received by the Treasury as a result of the proposed Convention? In addition, would you, for the record, submit estimated cost to the Department of Treasury, IRS, or other U.S. Government entities responsible for enforcing the terms of the Convention?

Answer. It is impossible to determine which individuals will be affected by the proposed Convention, since that depends upon the domicile of individuals at the time of their death or their gifts, and upon what property such individuals own at such times. The Treasury does not have statistics on the number of U.S. citizens living in France or French citizens living in the United States, who might be affected by the domicile determination rules of the Convention; nor does it have reliable data concerning the amount of U.S. situs property held by French domiciliaries, or French situs property held by U.S. domiciliaries, the taxation of which might be affected by the allocation of tax jurisdiction effected by the Convention.

The Treasury believe, however, that the Convention will not have a substantial revenue effect. This is because the Convention embodies a balance of concessions by the two sides, respective revenue effects of which are likely to cancel each other out. For instance, the Convention's domicile rules enable the U.S. to tax its citizens living in France if they have not lived there more than 5 to 7 years; to this extent, it is likely to result in a slight revenue gain to the U.S. On the other

hand, the Convention also restricts the rights of the U.S. to tax certain intangible U.S. property owned by French persons at the time of death; to this extent, it probably involves some revenue cost to the U.S. To the extent the Convention as a whole eliminates barriers created by potential double taxation to the free flow of goods, persons, and capital between the two countries, it probably results in a slight revenue gain to each country.

The Convention should not involve appreciable administrative costs to the U.S. Government. The rules of the Convention apply to estates, gifts, and generation-skipping transfers which even in the absence of the Convention would be subject to U.S. statutory law, and would therefore have to be subject to return requirements, audit and collection procedures, and the like, under statutory law. The Convention only results in substitute or supplementary legal rules governing the taxation of such transfers, and as such should not result any any measurable administrative costs.

THIRD PROTOCOL TO THE UNITED STATES-UNITED KINGDOM INCOME TAX TREATY

Question 13. Would you please summarize the British reaction to the reservation included in the Senate advice and consent to ratification last June 27, 1978, concerning Article 9(4).

Answer. The British tax authorities were unhappy with the Senate reservation concerning Article 9(4). They hoped that a modified version of Article 9(4) might be included in the treaty. When it became clear that there was no possibility of a modification which would be acceptable to all parties, they reluctantly agreed to seek Parliamentary approval of the treaty with the deletion of Article 9(4) but only after the Third Protocol is approved by the Senate. The British authorities view some of the provisions of the Third Protocol (particularly the North Sea permanent establishment rules) as a concession for the deletion of Article 9(4). We recently reconfirmed with the British their willingness to go forward with the treaty if the protocol is approved by the Senate.

Very strong objection has been raised by the U.K. business community to the deletion of Article 9(4). Many business and industrial groups in the U.K. have urged Parliament not to reapprove the treaty in the absence of the Article 9(4) provision.

The strength of these objections was confirmed by testimony at the June 6 hearings to the effect that there is a view among some Conservative Members of Parliament that the treaty should not be approved unless some solution can be found to the state taxation problem, albeit outside the treaty framework.

Question 14. Would any reservations added at this date jeopardize the Third Protocol and/or the U.S./U.K. Income Tax Treaty? If yes, please explain.

Answer. In our judgment any reservation on the Third Protocol, or any substantial delay in approval of the Protocol will seriously jeopardize the chances that the proposed U.S./U.K. Income Tax Treaty, with its very substantial benefits for U.S. taxpayers, will ever come into effect.

While we cannot speak for the United Kingdom, or predict with absolute certainty the actions which might be taken by the British Parliament, certain facts are clear. There is strong business opposition in the United Kingdom to the treaty reservation on Article 9(4) and as time passes there is also likely concern over the growing cost of the retroactive refund to U.S. investors of the British Advance Corporation Tax (it will be over $500 million through 1979). Despite this, the British have agreed to go forward to Parliament with the treaty as long as the U.S. Senate approves the Third Protocol containing what we, and they, view as a reasonable and justifiable provision clarifying the United Kingdom's taxing rights over certain offshore activities.

Should the United States again reserve on a treaty provision important to the British, particularly one which is reasonable in light of both the domestic tax law of the United States and the history of the basic treaty, it may well provide sufficient impetus for those in the United Kingdom opposed to the treaty to secure its defeat. Prolonged delay could have a similar effect.

Question 15. Why was the definition of a "permanent establishment" in the case of activities carried on offshore in connection with the exploration and exploitation of the seabed and subsoil modified? Will this modification result in a loss of revenues to the U.S.? If yes, how much? If no, why not?

Answer. The reasons for modification of the definition of the term "permanent establishment" are set forth in the answer to questions 6 and 7 under the General Questions heading above.

Since there is a good argument, and it is the British view, that the activities dealt with in the protocol provision may be taxed in the United Kingdom under the proposed treaty without the protocol, it is likely that the protocol provision will result in no additional loss of revenues to the United States. As a general matter, United Kingdom taxation of the income from exploration and exploitation connected activities of U.S. taxpayers will give rise to foreign tax credits which are available to offset the U.S. tax liability of U.S. taxpayers on this income. To that extent, the U.S. Treasury will lose revenue and the British Treasury will gain revenue. The magnitude of this revenue transfer, however, is not likely to be substantial. The information we have indicates that only a few U.S. drilling companies are actively operating in the British sector of the North Sea.

It is important to note that other provisions of the Third Protocol will raise U.S. revenues (*e.g.*, the limitation on the credit for the British Petroleum Revenue Tax) and thus, the net revenue impact of the protocol will be insignificant.

Question 16. How will the U.S. determine the United Kingdom source oil income for oil companies operating in the North Sea? Won't the oil companies be able to shelter oil-related income from other countries under the petroleum revenue tax (PRT) established by this convention?

Answer. The procedures for determining the treaty limitation on the credit for the U.K. Petroleum Revenue Tax (PRT) are described in the Treasury's technical explanation of the Third Protocol. For example, for purposes of this limitation, the taxable income from the extraction of minerals from oil or gas wells in the United Kingdom will be determined by applying principles similar to those under section 907(c)(1)(A) and section 907(c)(3) of the Internal Revenue Code.

As limited by the provisions in the Third Protocol, excess PRT should not spill over to offset U.S. tax on income from other countries.

Question 17. Will the Third Protocol, if ratified, result in a loss of revenues to the U.S.? If yes, how much? If no, why not? What was the policy reason for accepting the loss or gain?

Answer. We do not believe that the Third Protocol will, on balance, have a significant impact on U.S. revenues, either positive or negative.

QUESTIONS ON THE UNITED KINGDOM ESTATE AND GIFT TAX TREATY

Question 18. Explain the origin and development of the model estate and gift tax convention published by the Department of Treasury in 1977?

Answer. The U.S. Treasury Department released its "model" estate and gift tax treaty on March 16, 1977. The model serves as a statement of the Treasury's basic treaty negotiating position. It was developed over several months by Office of Tax Policy staff members conversant with estate and gift tax treaty issues. The general principle underlying the model is to grant to the country of domicile the right to tax the worldwide estate or gifts of a decedent or donor, with a credit for tax paid to the other State with respect to real property and business assets located therein.

The emphasis on domiciliary-basis taxation also explains the origin of the model. All U.S. estate and gift tax treaties negotiated between 1946 and 1956 contain a comprehensive set of situs rules. Double taxation is eliminated by awarding the situs state the primary right to tax a given type of property. In 1966, however, the Organization for Economic Cooperation and Development (OECD) published a model estate tax convention (Draft Double Taxation Convention on Estates and Inheritances). The OECD model, which the United States helped develop, provides for domiciliary-basis taxation. This is also the approach of our only estate tax treaty which has come into force since 1956, the United States-Netherlands treaty of 1971. Thus, the U.S. model estate and gift tax treaty reflects both the internationally-accepted concepts in the OECD model and our current treaty position.

Question 19. Does the U.S.-U.K. Estate and Gift Tax Treaty differ from the U.S. model treaty, and if so, please explain the policy reasons for the difference?

Answer. The U.S.-U.K. Estate and Gift Tax Treaty is similar, but not identical, to the model. It is similar in that both follow the principle of domiciliary-basis taxation. That is, the country of domicile may tax the worldwide estate or gifts of a decedent or donor. Immovable property and certain business assets are taxable in the Contracting State where situated.

The U.S.-U.K. treaty is different from the model in that it includes the tax on generation-skipping transfers, imposed by the Tax Reform Act of 1976. This

is purely a matter of timing. Although the model was not published until 1977, it was developed early in 1976. Consequently, it does not include the estate and gift tax modifications in the Tax Reform Act of 1976, which was signed in October of that year. Unlike the model, the U.S.-U.K. treaty does not provide for a reciprocal exemption of $30,000 for property that is taxable under the treaty on a situs basis. This part of the model refers to pre-Tax Reform Act of 1976 law; the $30,000 exemption was converted to a $3,600 credit by the 1976 changes. This provision is not in the treaty because the U.K.'s capital transfer tax does not apply to the first £25,000 (roughly $50,000) of property transferred.

Question 20. How does the U.S.-U.K. treaty define domicile and how, or why, was this definition selected?

Answer. The determination of a single treaty domicile is very important, since the country of domicile has the primary right to tax the worldwide estate and gifts of a decedent or donor, with the exception of property taxable under the situs articles. Domicile is determined initially under the law of each Contracting State. Under the treaty, an individual is domiciled in the United States (a) if he was a U.S. resident or (b) if he was a U.S. national, and had been a resident in the United States at any time during the preceding three years. The Convention uses the term "resident (domiciliary)" because U.S. domestic law equates the term "resident" with the term "domiciliary." The three-year rule simply parallels a provision in the U.K. capital transfer tax that a U.K. domiciliary will be deemed to be domiciled in the United Kingdom for a period of three years after a change of domicile is actually made. An individual is domiciled in the United Kingdom if he is (a) a U.K. domiciliary under general principles of U.K. law, or (b) treated as a U.K. domiciliary for purposes of the capital transfer tax.

The Convention provides rules for determining a single treaty domicile when a decedent or transferor is domiciled, under the laws of the respective countries, in both States. Particularly important in this regard is the provision that a U.S. citizen, who is considered under the Convention to be domiciled in both the United Kingdom and the United States, shall be deemed to be domiciled in the United States if he had not been resident in the United Kingdom for 7 of the last 10 years. This rule is based on the concept that a Contracting State should not tax the estate or other transfers of an individual on a domiciliary basis if the individual has not been present in that State for a significant period of time. If the 7 out of 10 year rule does not apply, the single treaty domicile is determined by a set of tie-breaking rules based on: permanent home, center of vital interests, habitual abode, state of nationality, or mutual agreement. These tie-breaking rules are similar to those in both the OECD and U.S. model treaties and in our existing estate tax treaty with the Netherlands.

Question 21. By using a worldwide basis to determine the domiciliary States' right to tax estates and transfers, will the U.S. increase or decrease its tax revenues from estate and gift taxes? By what amount? Please give policy reasons for any projected increase or decrease.

Answer. Generally, the United States taxes the estates and property transfers of its citizens and residents (domiciliaries) on a worldwide basis under its statutory law. Thus, use of a worldwide basis under the treaty does not represent a material departure from our normal estate and gift tax base.

This treaty, like others, is a balanced package of mutual concessions where there may be revenue gains from some provisions and revenue losses on others but, where the net revenue effect is nil.

Question 22. Why was the 7 out of 10 year rule used for the determination of domicile under the treaty?

Answer. A basic concept of United States tax policy in this field is that a Contracting State should not tax the estate or other transfers of an individual on a domiciliary basis if the individual has not been present in that State for a significant period of time. Conversely, where an individual has been present for a significant period of time we believe that it is reasonable to permit the State to tax the individual's accumulation of wealth. The 7 out of 10 year rule represents, in our judgment, a sufficiently long period of presence to justify taxation and has been our treaty policy for a long time. The rule is incorporated in the existing estate tax treaty with the Netherlands which entered into force in 1971.

It is also important to point out that a U.S. citizen will not automatically be deemed to be domiciled in the United Kingdom if he has been resident there for, say, 7 out of 10 years. In that case the determination of a single treaty domicile is settled by the tie-breaking rules. These are based on the concepts of permanent home, center of vital interests, habitual abode, nationality, and mutual agreement.

Thus, it is possible that an individual could be resident in the United Kingdom for more than 7 years and still be treated as a U.S. domiciliary, if, for example, he maintained a permanent home in the United States.

QUESTIONS ON THE UNITED STATES-HUNGARY INCOME TAX TREATY

Question 23. How does the 1977 model convention of the Organization of Economic Cooperation and Development (OECD) *differ* from the U.S. model income tax convention?

Answer. Among the primary differences between the U.S. and OECD models are that the United States reserves its right under its model to tax U.S. citizens in accordance with U.S. law even if they are residents of the other treaty country and that U.S. treaties cover only Federal income taxes except for purposes of nondiscrimination where all taxes are covered. The OECD model deals with taxation of residents of each country and does not make an exception for nonresident citizens, and covers state and local income and capital taxes as well as those at the national level. In addition, the U.S. model provides for exemption at source on interest (taxation only in the country of residence) whereas the OECD model allows a 10 percent tax at source. The U.S. model includes somewhat broader provisions for adjusting the income of related persons and exchanging information and provides for limited assistance in collecting taxes reduced on payments to persons not entitled to the treaty reductions. There are a number of lesser differences, primarily technical in nature. A summary comparison of the two models is given in the attached memorandum.

Question 24. Will the proposed Hungarian Convention result in a net loss or gain to the U.S. tax revenues? If gain, how much? If loss, how much? What are the underlying policy reasons for any projected loss or gain?

Answer. The revenue consequences of the treaty for the foreseeable future are negligible. The reductions in Hungarian tax will primarily benefit U.S. investors by reducing excess credits of joint ventures and eliminating the need to file tax returns by individuals and companies whose contacts with Hungary are limited. The U.S. rate reductions on outgoing dividends, interest and royalties represent a potential revenue cost but the level of such payments is insignificant.

Question 25. The submittal letter from the Secretary of State to the President mentions that the convention provides "for exchange of information and administrative cooperation between the tax authorities of the two countries to avoid double taxation," how, or in what form will this exchange and/or cooperation take place?

Answer. The exchange of information and administrative cooperation provisions are taken from the U.S. model treaty and appear in several other U.S. treaties. The tax authorities agree to cooperate with each other in applying the convention to avoid double taxation and prevent tax evasion. The United States would furnish Hungary with copies of withholding forms on payments of U.S. income, such as dividends and interest subject to withholding, to residents of Hungary (not U.S. citizens). Safeguards are provided to protect secrecy and avoid undue administrative burdens. The tax authorities may consult by letter or in person whenever a question arises.

Question 26. Will the ratification of U.S.-Hungary Income Tax Treaty encourage private U.S. capital investment or activity in Hungary? If yes, have there been any projections or studies as to the level of investment or activities?

Answer. The ratification of the treaty would signal to U.S. and Hungarian investors that familiar tax rules apply and sound tax relations exist between the two countries. This would support and encourage the interest of investors in both countries, but it is one factor and cannot be quantified separately. Interest already exists. For example, Control Data, Katy Industries (shoes) and Levi Straus are already actively in Hungary and Hungarian companies are producing light bulbs, marketing pharmaceuticals, and engaging in a going venture with Corning Glass in the United States. The treaty would help the expansion of these activities by clarifying the tax rules in advance.

QUESTIONS ON THE UNITED STATES-KOREA INCOME TAX TREATY

Question 27. This Committee ordered printed the "Tax Convention with the Republic of Korea" on April 25, 1978. Have any factors surrounding the treaty, or the treaty itself, been changed or modified?

Answer. There have been no changes either in the Korean treaty itself or in the factors surrounding the treaty since the Committee action on the treaty in April 1978.

Question 28. Will this treaty result in a loss or a gain to U.S. tax revenues? If a gain, how much? If a loss, how much? Please explain the policy reasons for the loss or gain.

Answer. We do not believe that the treaty with Korea will, on balance, have a significant impact on U.S. revenues.

Question 29. What are the policy reasons for the special exemption from U.S. social security taxes for Korean residents who are temporarily present in Guam?

Answer. The exemption in Article 25 for Korean residents temporarily working in Guam was a matter of great importance to the Korean negotiators. The Koreans argued that as long as Philippine workers in Guam are exempt from social security tax by virtue of section 3121(b)(18) of the Internal Revenue Code, the Korean workers cannot compete with workers from the Philippines. Since neither Philippine nor Korean workers are likely ever to be eligible for U.S. social security benefits, the comparison of Korean workers with Philippine workers seems more relevant than their comparison with either U.S. or Guamanian workers, who are subject to tax, but will also be eligible for benefits.

The Treasury found this position reasonable. Our concern (as well as that of the Koreans) is not with providing exemption in all cases for Korean workers, but rather with assuring that Korean workers are treated equitably vis-a-vis Philippine workers.

Question 30. Are there any plans for further negotiations with Korea in other tax areas?

Answer. There are no plans at present for further negotiations with Korea either to modify the income tax treaty or to deal with other taxes.

Question 31. Will the proposed U.S.-Korea Income Tax Treaty promote the investment of private U.S. capital in Korea? Do you have any studies or projections?

Answer. It is reasonable to expect that the income tax treaty with Korea will have a positive impact on U.S. investment in Korea. The presence of a treaty creates a favorable climate for investment by assuring against capricious changes in the tax regime faced by U.S. investors and by creating a mechanism for the resolution of disputes which may arise in the taxation of flows of income between the two countries. Furthermore, the reductions in Korean withholding rates will, in many cases, directly increase the rate of return for U.S. investors on investment in Korea and on transfers of technology to Korea. It is not possible, however, to quantify these effects, in part, because the applicable tax rules are but one of the factors taken into account in making investment decisions.

Material Referred to in Question 1 on the Treaty With Hungary

THE UNITED STATES MODEL INCOME TAX TREATY

(Submitted by the Department of Treasury, United States of America, for the XIX Inter-American Center on Tax Administrators (CIAT) Technical Conference on "Exchange of Information Under Tax Treaties", August 28-September 3, 1977, Curacao).

INTRODUCTION

In May of 1976, the United States Treasury Department first released the text of its Model Income Tax Treaty. The current version of the U.S. Model, which differs from the 1976 Model only in minor respects, was released on May 17, 1977.

The U.S. Model is patterned after the Model Income Tax Treaty of the Organization for Economic Cooperation and Development (OECD Model), and closely follows that model both in substance and in form. The United States uses this Model as the basis for conducting negotiations with all countries. Although the United States does not have a model treaty specifically tailored for negotiations with developing countries, it is prepared to vary somewhat from the standard Model provisions in those negotiations.

In describing the U.S. Model, it is perhaps most useful to discuss the principal differences between it and the OECD Model. This paper analyzes the principal differences between the two models on an article by article basis. It should be emphasized that although the primary focus of this paper is on the differences between the two models, the U.S. Model differs from the OECD Model in relatively few instances, and the differences are often minor.

I. SCOPE OF THE TREATY

The first two articles of both the U.S. Model and the OECD Model define the personal scope of the treaty and the taxes covered. The differences in the scope of the two models are discussed below.

1. *Personal scope.*—In delimiting the personal scope of the treaty, the most significant departure in the U.S. Model from the OECD Model is the reservation to each Contracting State of the right to tax its own residents and nationals as if the treaty did not come into effect. This provision overrides any other provision that would otherwise limit the authority of a Contracting State to apply its internal tax law to its citizens or residents. The only exceptions to this rule relate to provisions that are clearly intended to limit the authority of a Contracting State to tax its citizens or residents. The provisions of the treaty relating to the foreign tax credit, non-discrimination and the mutual agreement procedure are examples of those exceptions. The reason for this provision, known as the "saving clause", is that the United States views treaties as affecting a Contracting State's right to tax residents and citizens of the other Contracting State, and not as affecting its right to tax its own residents and citizens.

Under the saving clause, the United States retains it statutory right to tax its citizens and residents on worldwide income. The United States also retains the right to tax a former citizen on U.S. source income for a 10-year period if the former citizen renounced citizenship to avoid U.S. taxes.

In addition to this reservation of the right of each Contracting State to tax its own citizens and residents, the U.S. Model also clarifies that some of the treaty provisions apply to persons that are not residents of either of the Contracting States. The OECD Model makes this clarification in later provisions of the treaty.

2. *Taxes covered.*—With respect to taxes covered by the treaty, the U.S. Model contains two differences from the OECD Model. A minor difference is that the U.S. Model focuses on a specific list of taxes covered and does not contain a general discussion of those taxes. A more significant difference is that, except for purposes of the Non-Discrimination Article, income and capital taxes imposed by local subdivisions of the United States are not covered by the treaty. These local U.S. taxes are not covered because it is unlikely that the United States would consent to the ratification of any treaty provision that restricted the rights of the various states to impose their own taxes.

II. DEFINITIONS OF TERMS

The U.S. Model closely follows the OECD Model in Articles 3, 4 and 5. Those articles define the general terms used in the treaty, such as "person", "company", "enterprise of a Contracting State", "international traffic", "resident of a Contracting State" and "permanent establishment". The few differences between the definitions used in the two models are described below.

1. *Definition of "person".*—The U.S. Model includes partnerships, trusts and estates in the definition of a "person". This difference is merely an attempt to clarify that those legal entities are covered by the treaty.

2. *Definition of "international traffic".*—The term "international traffic" is in the U.S. Model solely in terms of transport. The OECD Model definition of "international traffic" is phrased in terms of transport by a ship or aircraft operated by an enterprise which has its place of effective management in a Contracting State. If the enterprise operating the ship or aircraft has its place of effective management in its State of residence, then the U.S. Model definition of "international traffic", together with the substantive provisions of the Shipping and Air Transport Article, results in the same tax treatment of profits from shipping and air transport as that in the OECD Model.

3. *Undefined terms.*—Both the U.S. Model and the OECD Model provide that for purposes of applying the treaty to its own taxes, each Contracting State will look to its domestic law for the definition of terms not defined in the treaty. The U.S. Model makes the resolution of undefined terms subject to the mutual agreement procedure. This provision may be implicit in the OECD Model.

4. *Definition of "resident of a Contracting State".*—Under both models, treaty benefits are generally conferred only on a resident of a Contracting State, and a person is considered a resident of a Contracting State only to the extent that the person is subject to tax in that State on income from sources both within and without that State. In the interest of clarification, the U.S. Model contains

rules for applying this limitation to the income of partnerships, trusts, and estates, and to income taxed in a Contracting State on a remittance basis. In addition, because the United States taxes on the basis of U.S. citizenship and incorporation in the United States, citizenship and place of incorporation are added to the criteria for determining residence.

The tie-breaker rules in the U.S. Model for determining a unique residence for individuals generally follow the OECD rules. However, because the United States does not recognize the concept of place of management, the tie-breaker rule for dual resident corporations in the U.S. Model is structured in terms of place of incorporation. The U.S. Model also provides that the competent authorities of the two States are to determine residence in other dual residence situations.

Finally, the U.S. Model includes as a "resident of a Contracting State" nationals of that State engaged in the performance of government services for that State, and members of their families, even though they may reside in the other Contracting State or in a third State. This broadened definition of "resident" is intended to extend the benefits of the treaty to government employees and families who are employees of a Contracting State and are taxed in that State on a worldwide basis.

5. *Definition of "permanent establishment".*—With minor exceptions, the U.S. Model definition of "permanent establishment" is identical to that in the OECD Model. The first exception is that under the U.S. Model, if a place of management in a Contracting State does not have other attributes of a permanent establishment, then it does not constitute a permanent establishment. It is, however, difficult to envision the circumstances under which there could be a place of management that does not have other attributes of a permanent establishment.

Second, the U.S. Model provides that an installation, drilling rig or ship used for the exploration or development of natural resources constitutes a permanent establishment only if it lasts more than 24 months. The assumption underlying this provision is that the installation, rig or ship is analagous to a construction project and should be treated in the same manner. There is no similar provision in the OECD Model, but the OECD Commentary recognize the provision in the U.S. Model as one of three acceptable means of dealing with activities of exploration of natural resources.

Third, the U.S. Model provides that the maintenance of a fixed place of business solely for any combination of the activities listed in the OECD Model as exceptions to the definition of a permanent establishment will not result in the presence of a permanent establishment. The assumption underlying this provision is that an enterprise of one Contracting State maintaining a place of business in the other Contracting State solely for a combination of these activities is engaging only in activities of a preparatory or auxiliary character.

III. RULES FOR TAXATION OF SPECIFIC CATEGORIES OF INCOME AND ASSETS

Articles 6 through 22 of the OECD Model set forth rules for the taxation of specific categories of income and capital. The purpose of these rules is to eliminate double taxation and to provide source rules for applying the general relief from double taxation provisions of Article 23. Under these 17 articles, either the State of source or the State of residence exempts specific types of income or capital from tax or subjects them to reduced rates of taxation. The U.S. Model follows the basic structure and substance of the OECD Model in these 17 articles. The principal differences between the two models as they relate to each category of income or capital are discussed below.

1. *Income from immovable property.*—In the U.S. and OECD Models, the primary right to tax income from immovable property is vested in the State in which the property is situated. The U.S. Model further provides for an election to be taxed on the income from immovable property on a net basis. U.S. tax law unilaterally provides that residents of other countries may elect to be taxed in the United States income from real property on a net basis.

2. *Business profits.*—The U.S. Model closely follows the OECD Model in the treatment of business profits. In both models, business profits of a resident of one Contracting State are not taxable in the other Contracting State unless the resident has a permanent establishment in that other Contracting State. There are, however, some minor differences between the two models.

First, the U.S. Model refers to "business profits", rather than to "profits". The reference to "business profits" merely clarifies that the OECD term "profits"

includes only income from business and not any other income. If this interpretation is not used, Article 22, dealing with other income, would have no significance.

Second, for the purpose of determining which profits are attributable to a permanent establishment, the U.S. Model requires arms-length dealings between all related entities, not just between the permanent establishment and its home office. Third, the U.S. Model specifies that in determining the profits of a permanent establishment, a deduction is allowable for a reasonable allocation of research and development expenses, interest and other expenses incurred for the enterprise of which the permanent establishment is a part. This change generally puts into the text of the treaty the apparent intent reflected in the OECD Commentary.

Fourth, because the United States does not determine profits attributable to a permanent establishment through an apportionment method, the apportionment provision of the OECD Model is deleted.

Finally, the U.S. Model contains a definition of the term "business profits", and specifically includes in that definition income derived from the rental of tangible personal property and motion picture, television and radio tapes and films. This definition is provided to more precisely delineate the types of income subject to the permanent establishment rules and to taxation on a net, rather than gross, basis.

3. *Income from shipping and air transport.*—There are three differences between the U.S. Model and the OECD Model with respect to the taxation of income from shipping and air transport.

First, in the U.S. Model, profits from the operation of ships or aircraft in international traffic are subject to tax only in the country of residence of the operator of the ship or aircraft. Under the OECD Model, the State in which the place of effective management of the operator is located has the exclusive right to tax. The difference between the two models exists because U.S. tax laws do not contain a concept of place of effective management. However, there is no substantive difference between the OECD rule and the U.S. rule in cases in which the enterprise operating the ships or aircraft has its place of effective management in the State of its residence.

Second, the U.S. Model deletes the OECD Model provision relating to shipping on inland waterways because foreign ships do not operate on U.S. inland waterways and it is unlikely that U.S. ships will operate on inland waterways of foreign countries.

Third, the United States Model clarifies that profits from the rental of ships or aircraft operated in international traffic, profits that are incidental to international transport, and profits from the rental of containers used for transport in international traffic are exempt from taxation in the State of source. The applicability of these rules is generally acknowledged in the OECD Commentary.

4. *Profits of associated enterprises.*—The scope of the provision in the U.S. Model for allocating profits between related enterprises is broader than the scope of the OECD provision in that it extends the right of the Contracting States to distribute, apportion or allocate income, deductions, credits or allowances between related parties that are residents of the Contracting States and of third States.

5. *Dividends.*—In addition to minor drafting differences, there are two substantive differences between the U.S. Model treatment of dividends and that of the OECD Model. First, the U.S. Model provides that a recipient of a dividend that owns 10 percent of the stock of the company paying the dividends qualifies for the 5 percent rate of withholding. The U.S. Model applies the 10 percent ownership rule, rather than the 25 percent ownership rule of the OECD Model, because U.S. tax laws distinguish between direct investment and portfolio investment for foreign tax credit purposes at the 10 percent level of stock ownership. Second, the U.S. Model embodies in the treaty a basic concept of U.S. tax law that one Contracting State may tax dividends paid by a resident of the other Contracting State to the extent attributable to the profits of a permanent establishment in the taxing State, but only if those profits account for at least 50 percent of the gross income of the corporation paying the dividends.

6. *Interest.*—The principal difference between the U.S. Model and the OECD Model in the treatment of interest income is that the U.S. Model exempts interest payments from withholding at source, while the OECD Model provides for a 10 percent rate of tax withholding. In the U.S. view, a 10 percent rate of tax withholding at source fails to adequately recognize that there are often substantial

expenses associated with interest income. Thus, even a relatively low rate of tax withholding on gross interest may translate into a very high rate of tax on net interest income.

7. *Royalties.*—The U.S. Model treatment of royalties is essentially the same as that in the OECD Model. However because income from the rental of motion picture films, films and tapes for use in television and radio broadcasting and industrial, commercial and scientific equipment is taxed as business profits in the U.S. Model, that income is excluded from the definition of the term "royalties". In cases where an enterprise of one Contracting State has no permanent establishment in the State of source of the royalties, there is no substantive difference, between the U.S. Model and the OECD Model; in both cases, those royalties are not subject to tax in the source State. Also, under the U.S. Model, gains from the alienation of industrial property are taxed as royalties to the extent contingent on productivity or sales, because contingent payments more closely resemble royalties than gain.

8. *Capital gains.*—The U.S. Model treatment of capital gains differs from that in the OECD Model only in that gains derived by an enterprise from the alienation of ships, aircraft or containers operated by that enterprise in international traffic are taxable only in the State of residence of the operator rather than in the State in which the enterprise has its place of effective management. This difference results from the absence in U.S. tax laws of a concept or place of effective management of an enterprise. If the enterprise conducting the international transport operations has its place of effective management in the State of which it is a resident, there is no substantive difference between the two models in the taxation of those gains.

9. *Income from the performance of independent personal services.*—The principal difference between the two models in the treatment of income from the the performance of independent personal services is that the U.S. Model permits a Contracting State to tax a resident of the other Contracting State on that income if the person performing the services is present in that State for more than 183 days during the year. Under the OECD Model, if the person performing the services does not have a fixed based in the taxing State, he would not be subject to taxation in that State irrespective of the length of his presence in that State. In the U.S. view, residents of the taxing State find it objectionable that a resident of the other Contracting State can be present in the taxing State for more than half the year and not be subject to tax on earnings from personal services performed there. The 183-day rule of the U.S. Model is consistent with the 183-day rule in the Dependent Personal Services Articles in both the OECD and the U.S. Models and is also consistent with the laws of many countries that use a six-months presence test for determining residence.

The U.S. Model also makes two classifications to the OECD Model. First, the U.S. Model clarifies that the independent personal services provisions apply only to individuals. Second, the U.S. Model uses the term "personal services", rather than the OECD term "professional services", to clarify that all independent personal services are covered by Independent Personal Services Article.

10. *Income from the performance of dependent personal services.*—With respect to the taxation of income from the performance of dependent personal services, the U.S. Model differs from the OECD Model only in that the taxation of remuneration derived in respect of an employment as a member of a regular complement of a ship or an aircraft operated in international traffic is reserved to the State of residence of the operator of the ship or aircraft rather than to the State in which the place of effective management of the operator is situated. The results reached in the two models are the same if the enterprise engaging in the international transport has its place of effective management in the State of its residence.

11. *Directors fees.*—Unlike the OECD Model, the U.S. Model contains no provision specifically addressing the taxation of directors' fees. The position in the U.S. Model is that directors' fees should be taxable as income from the performance of dependent personal services if the director is an employee of the company paying the directors' fees, and as income from the performance of independent personal services if the director is not an employee of that company.

12. *Investment or holding companies.*—The U.S. Model contains a separate article designed to limit the opportunity for third country residents to take advantage of the treaty benefits by organizing a holding or investment company in one of the Contracting States. There is no comparable provision in the OECD Model. However, the Commentary to the OECD Model indicates that it may be

appropriate to provide for special treatment of investment or holding companies in bilateral treaties.

13. *Artistes and athletes.*—The only principal difference between the U.S. Model and the OECD Model in the treatment of income of artistes and athletes is that under the U.S. Model, income earned in one Contracting State by artistes and athletes resident in the other Contracting State is treated the same as income earned from the performance of independent or dependent personal services unless it exceeds $15,000 during the taxable year. Under the OECD Model, all the income is taxable in the State where the artistes or athletes performed. The rule in the U.S. Model reflects the view that cultural exchanges should be encouraged, and that in the absence of international tax avoidance, entertainers and athletes should not be singled out for special adverse tax treatment. The U.S. Model does recognize, however, the ability of those performers to earn very high remuneration in very short periods, and, for that reason, includes the $15,000 threshold. The U.S. Model also contains additional clarification in the provisions designed to counter tax avoidance schemes employed by entertainers and athletes.

14. *Pensions, annuities, alimony and child support.*—The OECD and U.S. Models contain virtually identical provisions for the taxation of pensions. The U.S. Model goes beyond the OECD Model in that it also sets out provisions regarding the tax treatment of social security payments and other public pensions, annuities, alimony, and child support. Under the U.S. Model, social security payments and other public pensions are taxable only by the paying state. In the United States, employee social security contributions are made with after-tax dollars and social security benefits paid by the United States are not taxed. Social security benefits paid by foreign governments to U.S. citizens and residents are normally taxed by the United States. However, in the U.S. Model, the United States gives up this tax on foreign social security payments in exchange for the agreement of the other Contracting State not to tax social securiy benefits paid by the United States to a resident of that other Contracting State. The other Contracting State is, however, permitted to tax the social security benefits that it pays to a resident of the United States.

The U.S. Model also provides that annuities may be taxed only by the State of residence of the person receiving the annuity, that alimony may be taxed only by the State of residence of the person receiving the alimony, and that child support payments are exempt from tax in both Contracting States. Pursuant to the Other Income Article of the OECD Model, annuities and alimony are taxed only by the State of the recipient's residence. Thus, the tax treatment of annuities and alimony is the same in both Models.

15. *Government service.*—The government service provisions of the two models are essentially the same. The U.S. Model does, however, contain a special provision to the effect that the motive of a spouse or a dependent child of an employee of the government of one Contracting State in becoming a resident of the other Contracting State will not affect the tax exempt status of that spouse or child in that other Contracting State if that spouse or child later becomes an employee of the government of the first Contracting State.

16. *Student and trainees.*—The only substantive difference between the U.S. Model and the OECD Model in the treatment of income of students, apprentices or business trainees is that the U.S. Model provides that the student, apprentice or trainee from one Contracting State temporarily present in the other Contracting State may elect to be taxed as a resident of the other Contracting State. By electing to be treated as a resident of the United States, a non-resident alien is permitted to take certain statutory deductions, allowances and exemptions that would not otherwise be available, and to file a joint income tax return. However, the person making the election must give up the benefits otherwise provided by the treaty for residents of his home State and will be taxed by the United States on worldwide income.

17. *Other income.*—The U.S. Model provides for essentially the same treatment of income not otherwise dealt with in the treaty as is provided in the OECD Model. A minor difference between the two models is that the U.S. Model clarifies that the Artistes and Athletes Article, as well as the Business Profits and the Independent Personal Service Articles, will override the Other Income Article if income not otherwise dealt with in the treaty is effectively connected with a permanent establishment or fixed base maintained in the taxing State by a resident of the other State.

18. *Capital.*—Although the United States does not currently impose taxes on capital, the U.S. Model contains substantially the same provisions as the

OECD Model. The only principal difference between the two models is that the U.S. Model reserves the right to tax capital represented by ships or aircraft operated in international traffic and related movable property to the State of residence of the operator of the ship or aircraft, rather than to the State in which the effective management of the operator is situated. However, there is no difference between the two models in this respect if the enterprise operating the ships or aircraft has its place of effective management in its State of residence.

III. RELIEF FROM DOUBLE TAXATION

Article 23 of both the U.S. and OECD Models contain detailed rules for the elimination of double taxation in cases in which double taxation is not otherwise accomplished in the treaty by the relinquishment of the right of the State of source or the State of residence to tax specific types of income or capital. This article is one of the few articles in which the U.S. Model does not follow the style of the OECD Model. The U.S. Model does not follow the OECD Model because traditionally most countries have devised their own provisions for relief from double taxation, and it is generally expected that this article of the OECD Model will be modified in bilateral treaties.

Consistent with U.S. tax laws, the U.S. Model employs a credit method of relief from double taxation for the United States. Essentially, the United States guarantees to its residents and citizens that they will be entitled to a credit against U.S. tax liability for foreign taxes paid on foreign source income. The guarantee embodies the U.S. statutory foreign tax credit both for taxes paid directly to the other Contracting States by the U.S. citizen or resident and for those foreign taxes paid by foreign corporations more than 10 percent owned by a U.S. corporation.

The U.S. Model permits the other Contracting State to set out its own method for avoiding double taxation. However, if the treaty partner uses a credit method, the United States requests that the credit cover the direct and indirect U.S. taxes paid on the business profits and also the withholding tax imposed by the United States on the dividends paid.

IV. ADMINISTRATIVE PROVISIONS

The remaining six articles of both the U.S. Model and the OECD Model contain provisions relating to the administration of the treaty. Those articles relate to non-discrimination, the mutual agreement procedure, exchange of information and administrative assistance, the effect of the treaty on diplomatic agents and consular officials, entry into force and termination.

1. *Nondiscrimination.*—The nondiscrimination provision in the U.S. Model differs from that in the OECD Model in several respects. First, the U.S. Model clarifies that nationals who are subject to tax by a Contracting State on worldwide income are not in the same circumstances as nationals who are not so subject. This provision enables the United States to continue its statutory scheme of taxing its citizens and corporations on their worldwide income, and of taxing non-resident aliens and foreign corporations only on investment income from U.S. sources and on income effectively connected with a U.S. trade or business. Second, the U.S. Model does not guarantee non-discriminatory treatment to stateless persons because it is felt that the coverage of stateless persons is inappropriate in a bilateral treaty. Finally, in the interest of clarity, the U.S. Model specifies in greater detail than the OECD Model the types of disbursements for which an enterprise of one Contracting State must be allowed a deduction by the other Contracting State on a non-discriminatory basis.

2. *Mutual agreement procedure.*—There are two minor differences between the Mutual Agreement Procedure Articles of the two models. First, the OECD Model generally requires a person to invoke the mutual agreement procedure in the State of which that person is a resident. The U.S. Model provides that a person may invoke that procedure in either the State of residence or the State of which he is a citizen. Second, the U.S. Model contains no limitation on the time period within which the mutual agreement procedure must be invoked, while the OECD Model requires that the procedure be invoked within a three year period.

3. *Exchange of information and administrative assistance.*—There are two differences between the exchange of information provisions in the U.S. and OECD Models. First, the U.S. Model provides for the exchange of information with respect to all national taxes, while the OECD Model applies only to the taxes covered in the treaty. Second, the U.S. Model contains an additional pro-

vision detailing the procedures relating to the collection of information and the form in which the information is to be provided to the requesting State.

The U.S. Model also contains a provision under which the Contracting States agree to render limited assistance to each other in the collection of taxes. This provision does not provide for general assistance in collection, but only of limited assistance necessary to prevent misuse of the treaty. The United States requests limited assistance in collection to prevent abuse of the address system (as opposed to a certification system or a refund system) which the United States uses in applying the treaty exemption or reduced withholding for dividends paid by U.S. corporations to residents of foreign countries.

4. *Effect of convention on diplomatic agents and consular officials, domestic laws and other treaties.*—The U.S. Model goes beyond the OECD Model provision concerning the fiscal privileges of diplomatic agents and consular officials in that it clarifies that the treaty does not limit any of the fiscal privileges otherwise provided under the laws of either Contracting State or under any other treaty or agreement between the Contracting States.

5. *Entry into force.*—In the entry into force provisions, the U.S. Model differs from the OECD Model in two very minor respects. First, the U.S. Model clarifies that the treaty has no effect until it has been ratified or approved in accordance with the constitutional procedures of each Contracting State. Second, the U.S. Model specifies in detail the effective dates for the application of the treaty.

6. *Termination.*—The U.S. Model provision relating to termination of the treaty differs from that in the OECD Model in that it provides for a five year minimum period during which the treaty is to remain in force. The OECD Model leaves the minimum period up to the Contracting States. As in the provision concerning entry into force, the U.S. Model also specifies in detail the effective dates for the termination of the treaty.

The CHAIRMAN. Last, let me say that we have a statement submitted by Mr. Richard C. Pugh, president of the U.S.A. Branch of the International Fiscal Association regarding the topic of today's hearing and I would ask that that be inserted into the record.

[Mr. Pugh's prepared statement follows:]

INTERNATIONAL FISCAL ASSOCIATION,
New York, N.Y., June 6, 1979.

PREPARED STATEMENT OF RICHARD C. PUGH

I am Richard C. Pugh, President of the United States Branch of the International Fiscal Association.

We appreciate this opportunity to testify before the Foreign Relations Committee on the important subject of international tax conventions.

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 5,000 persons, of which approximately 600 are in the USA Branch.

The Association conducts an international congress annually at which major issues of international taxation are discussed and for which published studies are prepared by representatives of the national branches and by a general reporter. In addition, the USA Branch sponsors seminars and other educational programs organized by its regional committees in major cities of the country.

THE ROLE OF TAX TREATIES IN INTERNATIONAL COMMERCE

In a previous submission to this Committee, we observed that 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 than ever in the past.

Unlike other areas, such as monetary affairs under the IMF and international trade under the GATT, there is no central international body charged with coordination of international tax policies or responsible for resolution of conflicts between two or more national taxing jurisdictions which result in international double taxation of income or property. Income taxes, which have a pervasive impact on all trade and investment, are left to bilateral dealing and harmonization of rules through the mechanism of income tax conventions. This is equally true for the very difficult problems posed by conflicting rules and approaches to the taxation of estates.

There is simply no means by which many of the complicated problems arising out of detailed differences in the tax laws of the countries that are the subject matter of the six treaties under examination today could be resolved other than through bilateral tax conventions.

The institutional attention of IFA has long been directed toward a continuing examination of tax treaty policy issues, and in recent years a particular focus of the USA Branch has been the U.S. tax treaty program. Because of the various disciplines and backgrounds represented by our diverse membership and our members' common interest in minimizing international double taxation we believe we are in a position to make a significant contribution to identifying and examining policy issues, both procedural and substantive, arising in connection with our tax treaty program. Our activities in this area are centered in a Tax Treaty Committee that has participated in public briefing sessions held by the Treasury on various treaties under negotiation, has prepared reports on these sessions and has organized educational programs on important treaty issues. Our efforts in the treaty area are premised on our belief that the use of tax treaties is an important component of U.S. foreign economy policy.

At this hearing, we wish simply to emphasize three points:

First, the United States lags far behind other industrialized nations in securing tax conventions. Canada, France, West Germany and most of the nations of Western Europe have considerably wider treaty networks than does the United States. The lag in the U.S. tax treaty program is particularly accentuated with respect to the developing countries. We believe that U.S. international economic objectives require that increased effort be devoted to expanding our tax treaty coverage.

Second, the procedures for reviewing and passing upon income tax treaties has been far more cumbersome and has moved far more slowly in the United States than in most of the other industrialized countries and, accordingly, continuing attention should be devoted to finding ways of speeding up these procedures.

Our third point sounds a more optimistic note. We believe that the Treasury Department has embarked on an important and constructive program to improve both its own policy-making procedures and the environment for Congressional consideration of tax treaties. Their current agenda, as indicated by the Joint Committee on Taxation and Senate Foreign Relations Committee statement of May 21, on "Tax Treaties: Steps in the Negotiation and Ratification of Tax Treaties and Status of Proposed Tax Treaties" is an impressive one and demonstrates that vigorous efforts are being made to deal with evolving problems created by new tax rules of both developed and developing countries.

Since our prior submission to this Committee, we are pleased to note and commend the recent efforts of the Treasury Department to schedule public briefing sessions at appropriate stages in pending treaty negotiations in order to inform the public of issues under discussion and provide an opportunity for public input on policy issues and negotiating positions. We believe that this effort by the Treasury, coupled with the publication of a "model treaty" as the starting point for United States negotiations and an effort to publish more detailed technical explanations of treaty provisions, demonstrates that significant institutional steps are being taken to enhance the quality and consequently the effectiveness of U.S. tax treaties.

Many of the tax agreements will represent to a large extent a standard form of agreement. However, as with all negotiated agreements between governments, if there are to be income tax treaties to harmonize diverse and sometimes conflicting tax rules, there must be some degree of compromise and modification of domestic laws. As with legislation, there may be differing views among taxpayers as to the merits of particular provisions. There will, therefore, from time to time be some controversial provisions. It is the responsibility of the Treasury and the Congress to formulate acceptable United States policy in this

regard. It is hoped that emphasis will be given to adoption of consultation procedures to enable the Treasury and the Congress to cooperate as efficiently and effectively as possible in developing policy with respect to new and sometimes controversial issues arising in the context of the U.S. treaty program.

The U.S. tax treaties make an important contribution to promoting international trade and investment by minimizing double taxation of income and property and by facilitating fair and effective administration of our tax laws as they apply to international activities. We therefore, have every hope and expectation Mr. Chairman, that this Committee and its staff, with close consultation with the Treasury Department, will give a high priority to prompt consideration of tax conventions as an important part of our foreign economic policy.

The CHAIRMAN. Gentlemen, we thank you all very much for appearing before our committee today.

This hearing is adjourned.

[Whereupon, at 12:27 p.m., the committee adjourned, subject to call of the Chair.]

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