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Tax Conventions Relating to Individuals and Corporations Abroad

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TAX CONVENTIONS RELATING TO INDIVIDUALS AND CORPORATIONS ABROAD

Tax conventions[1] arise from the desire of sovereigns to expand their foreign trade. The strongest incentive of individuals and corporations to risk capital and effort abroad in their own, and incidentally their country's, foreign trade is financial gain. When this gain is threatened because of double taxation by the governments of its domicile and of its commercial situs, the incentive is correspondingly lessened or lost.

The basis for a tax treaty is the desire of interested governments to avoid making the foreign trader's tax burden too onerous. By agreement, the treaty nations contract that one State will receive a particular tax, and that the other State will refrain from imposing its own. As a concomitant to what is a positive desire of the contracting governments, each conversely adds to these agreements certain provisions that will lessen the possibility of tax evasion.

Prior to the setting up of tax treaties, the United States government attempted to cope with some of the problems through provisions in the Internal Revenue Code. Sections of the Code still provide for protection outside of the treaty areas as well as for the implementation of treaties.[2]

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1. "A convention, by reason of its approval by the Senate is in a strict sense a treaty." It. 4019, 1950 I. R. B.-16, p. 7.

2. Section 22 (b) (8) which excludes from gross income earnings from sources outside of the United States must be read in light of section 116 (a) (1). This requires the individual citizen to satisfy the Commissioner that he is a *bona fide* resident of, and has received such income from, a foreign country or countries during the entire taxable year. The amended section 116 (a) (1) of the 1951 Code now allows exclusion for the entire period over one year abroad. Exclusion will apply from the date of departure and continue until the date of return, even though the latter falls midway in another tax year. Nor is the exclusion for the year of return limited, as previously, to cases where the taxpayer has been a bona fide foreign resident for at least two years. Amounts paid by the United States, or an agency thereof, are not considered to be from without the United States. The troublesome problem of bona fide residence may to some extent be vitiated by the new sub-section 116 (a) (2) of the 1951 Code which excludes income earned by a citizen who during any period of eighteen months is *present in a foreign country or countries* for at least 510 full days. The section only requires *presence,* not bona fide residence. If the taxpayer elects to exclude his income earned abroad from gross income, he waives the right to deductions which are properly allocable or chargeable to such excluded amounts (Section 131 (a) (3)). Section 1621 (a) (8) (A), as amended, makes further concessions. Thus, where an employer has reasonable cause to believe his employee's remuneration will be exempt under 116 (a) (1) or (2), or if the employer is required to withhold under laws of any foreign country, there will be no tax withheld by the employer in the United States. When a taxpayer has been required to pay income, war-profits or excess-profits taxes outside of the United States, *and he is liable to taxation here on the same income,* the Code offers two alternate methods of relief. He may, under section 23 (c) (1) (C) take such foreign payment in the year paid

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TAX CONVENTIONS

Whatever concessions the Internal Revenue Code might make, the plight of Americans in foreign countries would still be difficult unless there were either a complete surrender of the right to tax payment by the United States or an agreement with the governments of countries in which the Americans were employed, to remove the burden of double taxation.[3]

There are presently ten tax treaties that have been signed and ratified by the United States and the contracting States.[4] Certain definable patterns may be discerned to greater or lesser degree in all of these conventions although the contents vary. In some treaties there is an attempt made to cope with special problems that will exist in one or two countries alone. For the sake of practicability we shall consider only the ten countries where ratification has created existing law.

HISTORY

The case of *Henry H. Kimball v. The Commissioner*[5] contains a succinct history of the development of modern tax conventions. Although provisions affecting the fiscal status of one or both nations' subjects have long been contained in various treaties, they have been matters incidental to the general treaty purpose.[6]

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or accrued (section 43) as a deduction from gross income *or*, in lieu of such deduction, he may elect under section 131 to be allowed a credit. This credit is limited by section 131 (b) (1) to the same proportion of the foreign tax which the taxpayer's net income from sources within the foreign country bears to his entire net income during the same taxable year. The *total* credit may not exceed the same proportion of the foreign tax that the taxpayer's net income from *all sources outside the United States* bears to his entire net income for the taxable year (Section 131 (b) (2)). Examples illustrating sections 131 (b) (1) and (2) are found in Regulations section 29.131-8. Thus, it is possible that the credit allowed on foreign income taxes paid to two or more countries abroad will be less than the credit allowed on the same amount of income taxes when paid to a single country.

3. "The conduct of negotiations looking to bilateral tax conventions and other tax arrangements between the United States and foreign countries, and (the) review of regulations under such conventions" is the duty of the Special Deputy Commissioner (C.C.H. par. 4004).

4. Canada (effective January 1, 1941: Supplementary Treaty, January 1, 1951); Denmark (effective January 1, 1948); France (effective January 1, 1945; Supplementary treaty and Protocol effective January 1, 1950); Ireland (effective as to U. S. tax January 1, 1951); Netherlands (effective January 1, 1947); New Zealand (effective as to U. S. tax January 1, 1951); Norway (effective January 1, 1951); Sweden (effective January 1, 1940); Switzerland (effective January 1, 1951); United Kingdom, effective July 25, 1946). Treaties signed and awaiting ratification: Belgium, Greece and Union of South Africa. Treaties in preparation: Argentina, Brazil, Columbia, Cuba, Finland, Israel, Italy, Luxembourg, Mexico, Philippines, and Uruguay.

5. 6TC535, p. 537.

6. Tulane Law Review, June, 1950, p. 395.

The problems of double taxation became serious in the years following the first World War. Committees were appointed by the International Chamber of Commerce and the League of Nations to study possible solutions to the dilemma.

The two committees co-operated in working out a uniform set of principles. In 1927 the League of Nations Committee of Technical Experts on Double Taxation and Tax Evasion submitted a model bilateral convention on double income taxation.

In 1928 the United States sent experts to a meeting in Geneva, Switzerland, attended by representatives from twenty seven countries. Here the experts adopted the model convention with modifications and formulated two additional variants. Subsquently, a number of treaties embodying principles contained in these drafts were entered into by various European countries.

In 1930 Mitchell B. Carroll was sent to Europe by the State Department to study what had been accomplished. He reported favorably on the League models; these were used as the basis of our first convention and, with modifications, of subsequent ones. A reciprocal tax treaty became effective with Canada August 13, 1937, retroactive to January 1, 1936.[7]

The history of income tax treaties is a short one, and the reason is obvious. During the several years prior to ratification of our first treaty, other nations had co-operated in a unique manner, allowing their tax experts to investigate the troublesome and growing problem. Certain compromises were made by these experts in their drawing up of models; and, in the acceptance of the principles contained in the models, nations, to an extent, gave up a bit of their sovereignty in an effort to solve problems common to them all. Evidence of the value of this form of international co-operation lies in the fact that the first treaty signed by the United States found our government starting at an advanced point in a new field. accepting many principles which are in force today.

TREATIES[8]

There are many problems involved in the complex adjustment of proper tax distribution. Particularly is this true with business ventures. There is the question of allocation of profits where manfacture is in one country, management in another and raw materials furnished from a third—not to mention shareholders resident in a fourth country who are citizens of yet another country. The bilateral treaties

7. Superceded by the present treaty. Although the treaty with Canada was the first ratified, others were in the "talking" stage.

8. "Taxes" Magazine, November, 1948, p. 1001, by Eldon P. King, Special Deputy Commissioner, covers then existing treaties with France, Canada, Sweden and the United Kingdom.

have helped eliminate much of the unfortunate tax consequences that might otherwise occur. However, more remains to be done. We will now examine the areas of activity covered by the treaties.

(a) *Business Activities.* Treaty countries eliminate from tax consideration business activities which are not classified as "permanent establishments."[9] In other words, sales representatives, commission agents or purchasing agents may act for a firm whose situs is in the other treaty State; but none of these representations will be cause for taxing the foreign enterprise since the agents' functions are not interpreted to be those of a permanent establishment.[10] The principle also applies indirectly to income from operation of aircraft and/or ships which are taxable only in the State where registered.[11]

(b) *Permanent Establishment.*[12] Where an enterprise or a corporation of one treaty country carries on a business activity in the other, which qualifies as a permanent establishment, the enterprise is taxable in the foreign state on all industrial and commercial profits derived therefrom as though it were independent from its parent organization.[13] However, the mere local purchase of merchandise by such establishment will not be considered in determining the tax.[14]

In taxing the industrial and commercial profits of a permanent establishment, certain items, such as dividends, income from real property, royalties, etc., are not considered, but are treated separately. These items vary with respect to different countries.

The United States reserves the right, however, to tax the entire income of a foreign enterprise owned by its own citizen or a domestic corporation even though such enterprise has also been taxed as a permanent establishment abroad.[15] To compensate for this double taxation, the United States allows a credit under

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9. Canada Art. I; Denmark Arts. II(c), III(1,2); France Tit. I, Art. 3; Ireland Art. III; Netherlands Arts. II(i), III; New Zealand Art. III; Norway Art. III; Sweden Art. II; Switzerland Arts. II(c), III; United Kingdom Arts. II (1), III.

10. Care must be exercised that the agent does not regularly conclude contracts or maintain a well stocked supply of merchandise for sale.

11. Canada Art. V; Denmark Art. V; French Tit. I, Art. 6; Ireland Art. V; Netherlands Art. VI; New Zealand Art. V; Norway Art. V; Sweden Art. IV; Prot. 16; Switzerland Art. V; United Kingdom Art. V; where there is no treaty, see Code 119 (e) (1), 212 (b) and 231 (d).

12. Canada Art. III, Prot. 3(f); Denmark Art. III; France Tit. I, Art. 3; Ireland Art. III(3); Netherlands Art. III; New Zealand Art. III (3,6); Norway Art. III; Sweden Art. II; Switzerland Art. III; United Kingdom Art. III.

13. Code Sections 14(c) (1) and 15.

14. See footnote 9 *supra.*

15. Canada Art. XVII, Prot. 11; Denmark Art. XV; France Tit. I, Art. 14, Prot. VI; Ireland Art. II(1) (g); Netherlands Arts. XIX(1), XXV(1); New Zealand Arts. XIX, II (1) (j); Norway Art. XIV, XX(2); Sweden Art. XXV(1), Prot. 9; Switzerland Art. XVIII(2).

section 131 of the Internal Revenue Code for the foreign tax. Unfortunately, this credit does not eliminate the inequity which arises where the foreign tax rate exceeds the United States rate or where the foreign operations are carried on through a subsidiary corporation.[16]

(c) *Intercorporate Relationship.* Where an American enterprise has a financial or managerial interest in a foreign enterprise, it may impose on the latter financial or commercial conditions different from those which would be made with an independent enterprise. When this happens, the proper authorities will estimate the profit that an arms-length operation would have returned, and such profit will be allocated to the proper enterprise for taxation.[17]

(d) *Dividends.* Section 231(a) of the Code provides that a foreign corporation, outside the western hemisphere and not engaged in trade or business in the United States, which receives a dividend from sources within the United States, will have levied upon such amount a thirty per cent tax. Under treaties with seven countries [18] this rate has been reduced to fifteen per cent as to a resident or corporation of the other contracting country if the recipient has no permanent establishment in the country from which the dividend is derived. Furthermore, if a foreign corporation controls at least ninety five per cent of the paying corporation, and no more than twenty five per cent of the latter's gross income consists of dividends or interest (save from subsidiaries of its own), the tax withheld is reduced to five per cent. Such reduction will not apply if the relationship of the two corporations has been arranged or is maintained primarily for the purpose of securing such rate.[19]

The subject of dividends arises in another respect. Under section 119(a) (2) (B), dividends received from a foreign corporation are treated as gross income *unless* less than fifty per cent of its income was derived from sources within the United States for the three year period prior to its declaration of dividends (or part of such period in which the corporation existed)— This section still applies to United States citizens; but if a corporation is organized under laws of certain treaty countries [20] and the recipient of its dividends is not a citizen, permament

16. "Taxes" Magazine, January, 1950, p. 9 (at p. 18); see limitation by Code Section 131 (b).

17. Canada Art. IV; Denmark Art. IV; France Tit. I, Art. 5; Ireland Art. IV; Netherlands Art. IV; New Zealand Art. IV; Norway Art. IV; Sweden Art. III; Switzerland Art. IV.

18. Sweden (Art. VII) has a rate of ten per cent. The treaties with France and Norway have no such provision.

19. Canada Art. XI, Prot. 6; Denmark Art. VI; Ireland Art. VI; Netherlands Art. VII; New Zealand Art. VI; Switzerland Art. VI; United Kingdom Art. VI.

20. Canada Art. XII; Ireland Art. XV; Netherlands Art. XII; New Zealand Art. XII; Switzerland Art. XIV; United Kingdom Art. XV.

establishment, or resident of the United States, then such dividends are specifically exempted from the United States tax.

(e) *Interest.* Section 119 (a) (1) (B) of the Code treats as part of gross income from sources within the United States interest received from the United States on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, but *not* interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation when less than twenty per cent of the gross income of such resident payor or corporation has been derived from sources within the United States during the prior three taxable years (or part thereof).

The treaty provisions in respect to interest are similar to those with respect to dividends in that the United States exempts from tax the interest derived from sources within the United States when it is received by a non-resident alien as to the United States who is resident in the treaty country or by a corporation organized in the treaty country and not having permanent establishment in the United States.[21] But this exemption will not apply where a corporation of the other treaty State controls the paying United States corporation to the extent of more than fifty per cent of the entire voting power.[22]

Where no treaty exists, the flat rate of thirty per cent applies to interest.[23]

(f) *Royalities.* Payments made for the use of copyrights, patents, secret processes, etc., in one treaty country to the owners of such rights in another treaty country are exempt from taxation in the former, or are taxable at a reduced rate.[24]

(g) *Capital Gains.* A reciprocal exemption exists in five treaties on payments made as gains resulting from the sale or exchange of capital assets within the country where made, if the recipient is not a permanent establishment.[25]

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21. Canada Art. XII; Denmark Arts. VII, IX(1); Ireland Art. VII; Netherlands Art. XII; Norway Art. VI; Switzerland Art. VII (no exemption; reduction to 5%); United Kingdom Art. VII.
22. Canada Art. XIII; Ireland Art. VII; Netherlands Art. VIII; United Kingdom Art. VII.
23. Code Section 231(a).
24. Thus, Canadian residents or corporations, not having permanent establishments in the United States, pay fifteen per cent instead of thirty per cent (Arts. XI, XIIIC); whereas the treaty with Denmark (Art. VIII) makes such royalty payments exempt altogether. This complete exemption is part of the treaties with France (Tit. I, Art. 7), Ireland (Art. VIII), the Netherlands (Art. IX), Norway (Art. VII), Switzerland (Art. VIII) and the United Kingdom (Art. VIII). There is a total exemption in the Swedish treaty (Art. VI) irrespective of whether there is a permanent establishment in the State granting the exemption. The New Zealand treaty (Art. VII) permits taxation on a net basis.
25. Canada Art. VIII; France Tit. I, Art. 11; Norway Art. IX; Sweden Art. IX; United Kingdom Art. XIV.

However, gains resulting from the sale of realty will be taxed only by the country having situs of the real property.[26]

(h) (i) *Governmental Salaries; Pensions and Life Annuities.* Section 116(h) of the Code provides that employees of a foreign government, whose functions are similar to those of United States employees abroad, shall be exempt from taxation on their wages, fees or salaries by the United States if reciprocal exemption is given employees of the United States government stationed in their country.

This provision has been incorporated in all existing treaties together with a clause to the effect that annuities and pensions paid to non-resident aliens will not be taxed by the other State from which such payments are made.[27] Without this agreement the beneficiaries of the income would be subject to taxation by both States.

(j) *Compensation for Labor or Personal Services.* Such compensation (generally including the practice of a liberal profession), when not governmental, is taxable only in the treaty State in which services are performed over a period of more than 183 days. (Two exceptions noted in footnote.)[28]

The treaty with France is unique in that the time within which these exemptions apply is any period or periods aggregating less than a taxable year.[29]

(k) *Visiting Professors or Teachers.* To encourage cultural exchange between countries, treaties with all countries except Sweden contain clauses exempting from taxation the earnings of teachers who come from one of the other contracting States for a maximum period of two years to teach at a university, college or other teaching establishment.[30] These persons remain subject only to tax in their own State of domicile.

26. Denmark Art. IX(1); France Tit. I; Art. 2, Prot. 11; Netherlands Art. V; Norway Art. VIII; Sweden Art. V; Switzerland Art. IX.

27. Canada Arts. VI, VIA; Denmark Art. X; France Tit. I; Art. 8; Ireland Art. X; Netherlands Art. XV; New Zealand Art. X; Norway Art. XI; Sweden Art. X; Switzerland Art. XI; United Kingdom Art. X.

28. Canada Arts. VII, VIIA; Denmark Art. XI (180 days); France Tit. I, Arts. 9, 10; Ireland Art. XI; Netherlands Art. XVI; New Zealand Art. IX; Norway Art. X; Sweden Art. XI (180 days); Switzerland Art. X; United Kingdom Art. XI.

29. Another special circumstance in the French treaty is that a person engaged in a liberal profession (e.g., law, medicine, engineering, sciences) is taxable in the State outside his residence only when he establishes an office or other fixed center of activity in the other State. There is no limit as to time, but care must be exercised in both instances that he does not become qualified as a resident (See Section 29.211-2 Regulations 111).

30. Canada Art. VIIIA; Denmark Art. XIV; France Tit. I, Art. 10; Ireland Art. XVIII; Netherlands Art. XVII; New Zealand Art. XIV; Norway Art. XII; Switzerland Art. XII; United Kingdom Art. XVIII.

(l) *Students or Apprentices.* A further provision exists in all treaties to the effect that students or business apprentices from one treaty State who visit the other treaty State for the exclusive purpose of study or acquisition of business or technical experience are exempt from taxation on remittances sent them by persons abroad for the purpose of maintaining them in their studies.[31]

(m) *Modes of Preventing Evasion (Exchange of Information and Collection).* The above paragraphs, (a) through (l), consist of benefits to the taxpayer. Tax treaties are also concerned with a tightening of loop holes that might permit a fraudulent evasion of taxes by individuals or corporations abroad. The seriousness of this problem is reflected in the number of articles in each treaty touching on exchange of information and assistance in collection. Generally, all treaties contain agreements for automatic exchange of information acquired in the normal fiscal inquiries of each contracting State.[32] This information concerns individuals or corporations in one treaty State who derive income from the other; income which would be difficult or impossible to discover by the State having the right to tax. The purpose is not only to discover undeclared income of residents or domestic corporations, but also to determine whether reductions or exemptions for foreign residents or corporations are validly requested. In addition to automatic exchange, some treaties mention specifically, and others generally, the right of one State to ask for information regarding a definite person or organization.

The information will not be given where its acquisition does not fall within legislative or administrative procedural methods of the State upon which demand is made, nor where such information will be opposed to its public policy, nor where it will disclose any trade secret or process.

Subject to similar qualifications respecting the sovereignty of each State, there are further clauses which require the contracting State to collect finally determined taxes owing to the other State, taxes which can only be reached by the former. The treaties with Canada, Ireland and the United Kingdom do not call for such aid; but the others do to varying degrees.[33]

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31. Canada Art. IX; Denmark Art. XIII; France Tit. I, Art. 12 (no mention made of apprentices but so interpreted by T. D. 5499); Ireland Art. XIX; Netherlands Art. XVIII; New Zealand Art. XV; Norway Art. XIII; Sweden Art. XII; Switzerland Art. XIII, United Kingdom Art. XIX.

32. Canada Arts. XVIII, XIX, XX, XXI; Denmark Arts. XVII, XIX, XXII; France Tit. III, Arts. 8, 9, 10, 11, 13(1), Tit. IV, Art. 16, Prot. VII; Ireland Art. XX; Netherlands Arts. XXI, XXIII, XXVI(2); New Zealand Arts. XVI, XVIII(2); Norway Arts. XV, XVI, XVIII, XXI; Sweden, Arts. XV, XVI, XVIII, XIX, XXI, Prot. 6; Switzerland Art. XVI; United Kingdom Art. XX.

33. Denmark Arts. XVIII, XXII; France Tit. III, Arts. 8, 12, 13(1); Netherlands Arts. XXII, XXVI(2); New Zealand Art. XVII; Norway Art. XVII; Sweden Arts. XVII, XIX, XXI, Prots. 10, 11, 12; Switzerland Art. XVI(2).

(n) *Equitable Avoidance of Double Taxation.* Cognizant of the fact that certain inequities might occur, violative of the purpose of the tax conventions, a similar clause has been included in all treaties with the exception of Ireland and the United Kingdom. It reads in effect, if a taxpayer can show proof of double taxation, with respect to taxes covered by the convention, the competent authorities of both States may confer to determine whether the double taxation can be avoided.[34]

As a result of voluntary consultations among nations, an entire field of international activity has moved toward a more clear definition. Where previously there was chaos and uncertainty, each succeeding treaty has made expanded trade more possible in a world beset by complicated tax problems. As the design of reciprocal treaties becomes more definite, the nations draw closer in common understanding and co-operation.

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34. Canada Art. XVI; Denmark Art. XX; France Tit. II, Art. 14; Netherlands Art. XXIV; New Zealand Art. XVIII(1); Norway Art. XIX; Sweden Art. XX; Switzerland Art. XVII.