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Erratum

Due to an oversight in transposition, two significant errors appear in Mr. Carroll's article in volume 27, number 2:

- Page 450, third line. For "has has" read "has no."
- Page 451, sixth line. For "is now" read "is not."

TAXATION OF U.S.-BASED TRANSNATIONAL CORPORATIONS

By MITCHELL B. CARROLL*

This article will examine the United Nations Commission on Transnational Corporations (TNCs) along with various U.S. tax treaties and their consequences. We will then look to the various tax systems existing in France, Britain, Germany, and Japan to see how TNCs have been taxed there. Although the examination focuses on the U.S.-based TNCs, the policy considerations may be valid in reverse, *e.g.*, as applied to foreign-based TNCs operating in the United States. Considering the increasing role and financial dominance of the TNC, an understanding of tax basics as applied in four countries, will hopefully give the practitioner a working flavor of the area.

I. BACKGROUND OF THE UNITED NATIONS COMMISSION ON TRANSNATIONAL CORPORATIONS

Apprehension may be caused when the program of the Commission on Transnational Corporations (TNCs) is considered against the background of the new United Nations Charter of Economic Rights and Duties of States¹ which is described by the United States Council of the International Chamber of Commerce as the "cutting edge of a threat to the well-being, and even the existence of foreign-owned private enterprise and to the security of foreign investment in many countries."²

In adopting the Charter, the less developed countries in the United Nations, including the OPEC group, plus the communist states (120 votes in the Assembly) overrode the opposition of the United States and a few other industrialized nations. The protagonists of this "new international economic order" may seek to accomplish their purposes in the new commission to regulate TNCs which are the instrumentalities of foreign investment. The Charter endorses expropriation without compensation and rejects international adjudication of economic disputes between a host coun-

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1. The full text of the Charter may be found at page 28 of the Report of the Second Committee. U.N. Doc. A/9946 (29 U.N. GAOR Supp. ____ at ____, U.N. Doc. A/____ (1974)) and in U.N. Doc. A./RES/3281 (XXIX), 29 U.N. GAOR Supp. ____ at ____ (1974).

2. U.S. COUNCIL OF THE I.C.C., A New Challenge to Private Enterprise, (April, 1975).

try and a foreign investor.³ Thus, an overwhelming majority of U.N. members voted to apply their own doctrines to the detriment of the United States.

The United Nations Conference on Trade and Development (UNCTAD), whose objective is to focus attention on the needs and claims of Less Developed Countries (LDCs), is working to benefit the "have-nots" in such fields as the transfer of science and technology, patents, restrictive business practices, trade, and trade preferences. At the third session of the UNCTAD at Santiago, Chile, in 1972, twin proposals were initiated for a U.N. Charter of Economic Rights and Duties of States, and for an examination of Multinational Corporations (MNCs) by the U.N. Mexico sponsored the Charter and the Allende regime proposed the investigation of MNCs.

Following the UNCTAD of 1964, a "caucus" of 77 less developed nations met in Algiers and decided to vote as a bloc in international bodies on many matters. It is still called the "Group of 77," although the number has steadily grown (presently to 106 or more). It was a member of this group that submitted its list of concerns at the 1975 session of the Commission on TNCs.

A major proposal of the 1972 UNCTAD Conference led to the U.N. establishing, in 1973, the Group of Eminent Persons to study the role of MNCs and their impact on the process of development.⁴ The Group's recommendations of June 1974 resulted in the decision of the Economic and Social Council for the Official Records (ECOSOC) to establish a U.N. Commission on TNCs and an Information and Research Center in the U.N. Secretariat to assist the Commission.

The special session of the U.N. General Assembly, in April 1974, adopted, despite U.S. reservations,⁵ a declaration establishing a "New International Economic Order"⁶ and a related program of action.⁷ A major-

3. Article 2(c) of the Charter provides in part that each state art. 11, 19

(c) To nationalize, expropriate or transfer ownership of foreign property. . . . In any case where the question of compensation gives rise to a controversy, it shall be settled under the domestic law of the nationalizing State. . . .

4. Among the important witnesses who appeared at Hearings held by the Group in New York and Geneva in the fall of 1973 were officers of American TNCs, such as: Emilio Collado, Executive Vice-President, Exxon Corporation; Gilbert Jones, Chairman, IBM World Trade Corporation, Jacques Maisonrouge, President, IBM World Trade Corporation, Thomas A. Murphy, presently Chairman of the Board, General Motors Corporation; John Powers, Chairman of the Board (retired), Pfizer, Inc.; Irving S. Shapiro, Chairman, E.I. duPont de Nemours and Co.; and Thomas Fahey, Vice-President, Sales, General Tire International Co. United Nations Department of Economic and Social Affairs, *Summary of the Hearings Before the Group of Eminent Persons to Study the Impact of Multinational Corporations on Development and on International Relations*. (ST/ESA/15; New York, 1974) (Sales No.: E.74.II.A.9).

5. See U.N. Doc. A/PV. 2229 at 41-50 (1974), reproduced in 13 INT'L LEG. MAT'LS 744 (1974).

6. G.A. RES. 3201, ___ U.N. GAOR Supp. ___ at ___, U.N. Doc. ___ (1974),

ity demanded the early adoption of a Charter for the establishment of this new economic order. The United States expressed reservations but reluctantly decided that the negotiations of a Charter might offer an opportunity to ameliorate the situation. However, in December 1974, the U.N. General Assembly, without significant consideration of the objections, alternatives, or proposals stressed by the United States and other advanced nations, adopted an "extreme" draft of the Charter. This was done despite the negative votes of Belgium, Denmark, Germany, Luxembourg, the United Kingdom, and the United States. Abstaining nations were Austria, Canada, France, Ireland, Israel, Italy, Japan, the Netherlands, Norway and Spain.

All this puts the executives of TNCs on notice that the overwhelming majority of members of the Commission on TNCs are not likely to favor a regime for the future such as has existed in the past. Accordingly, they should give the U.S. delegation their support in striving to maintain a fair economic order.

II. INITIATION OF U.N. STUDY ON TNCs

Transnational corporations⁸ were the subject of discussion at the first session, March 17-27, 1975 of the United Nations Commission on Transnational Corporations (TNCs).⁹ The Economic and Social Council for the Official Records had created the Commission on Transnational Corporations¹⁰ in conformity with paragraph 7 of Economic and Social Council Resolution 1913 (LVII) of December 5, 1974. This commission is to submit to the Council in the spring of 1976, a detailed program concerning the whole range of issues related to transnational corporations.

That the Commission on TNCs considers taxation a matter of paramount importance in connection with TNCs is manifest, because in its Report of the First Session, March 17-28, 1975, it lists "Transfer pricing and taxation" in a priority area for collecting information.¹¹ This subject

reproduced in 13 INT'L LEG. MAT'LS 715 (1974).

7. G.A. RES. 3202, ___ U.N. GAOR Supp. ___ at ___, U.N. Doc. ___ (1974), *reproduced in 13 INT'L LEG. MAT'LS 720 (1974).*

8. It should be mentioned that the generally used term "multinational corporations" was employed by the United Nations in many of its original staff reports. Nevertheless, members of the Andean group objected to this use of the term because that group had preempted its use to describe a corporation or enterprise with affiliates in two or more Andean countries. Hence, they advocated "transnational corporations" because it suggests a corporation moving across the border into another country.

9. The Commission is scheduled to hold its second session, February 17-27, 1976.

10. The background of the reports, hearings, and recommendations for the creation of the Commission is synthesized in a report prepared by this author for the President's Association, comprised of the top executives of some 1500 corporations (many of which are TNCs) of the American Management Association, New York. It is entitled U.N. PROPOSALS FOR THE REGULATION OF TRANSNATIONAL CORPORATIONS, AMA, SPECIAL STUDY NO. 59 (1975).

11. U.N. Doc. E/5655 E/C, 10/6 p.4 (1975).

is also listed as possibly requiring study.¹² "Taxation" was also described as a matter on which international agreements might be possible at a future date!¹³ The report could have added that over 900 agreements on avoidance of double taxation of income are listed in the U.N. Collection,¹⁴ and among them are those signed and ratified by the United States with 32 foreign jurisdictions.

III. HISTORY OF U.S. INCOME TAX TREATIES¹⁵

As part of the effort to avoid double taxation of income, in 1930 the author was sent by the State Department to the American Embassy in Paris to try to settle the problem of tax liability arising from the application of the French tax on income from securities, on two bases: first, on dividends paid by a French subsidiary to the American parent corporation; and secondly, on the basis of an arbitrary proportion (determined by the ratio of assets in France to total assets) of the dividends distributed by the U.S. parent to its shareholders in the United States. In the spring of 1930 we met in the *Palais du Louvre*, in the sumptuous office of the Minister of the Budget, who had jurisdiction over the taxes on income. Present was the Director General of Taxes, Marcel Borduge, whom we had met in London in 1927 at a League of Nations meeting of technical experts to draw up a model convention for the avoidance of double taxation. We had met again in 1928 in Geneva at a general meeting of government experts, which included top officials of some 27 nations, including the U.S.S.R. and China. As the model convention drawn in London would not fit the systems of many of the governments represented, the conference adopted two more. The one submitted by us embodied the credit for foreign taxes which had been in the U.S. law since 1918.¹⁶ It provided for a credit against the U.S. tax for foreign taxes paid on income from real estate, business profits from a permanent establishment, and income from personal services taxable where earned. The balance of the income would be exempt at source and taxable only in the country in which the recipient resided, or of which he was a citizen.

In Paris, we argued that the application of the French tax to a distribution of dividends by an American corporation in the United States was outside the jurisdiction of France. The director of the *Enregistrement*, which was charged with enforcement of the tax, responded that there was

12. *Id.*

13. *Id.* at p.12.

14. See League of Nations Document C.345, M.102, 1948 II, 45 *Collection of International Agreements and Internal Legal Provisions for the Prevention of Double Taxation and Fiscal Evasion*, 1 U.N. COLLECTION 249 (1928).

15. For a discussion of the development of U.S. treaties on double taxation see M. Carroll, *Evolution of U.S. Treaties to Avoid Double Taxation of Income*, 3 INT'L LAWYER 130-33 (1968).

16. The credit for foreign taxes which we proposed, copies the substance of the credit now provided for in the INT. REV. CODE of 1954 §§901-05, 26 U.S.C.A. §§901-05 (Rev. 1967).

no use presenting legal arguments because "in fiscal matters there was no justice!" ("*En matiere fiscale il n'y a pas de justice!*")

As the French administration was applying the tax both on dividends distributed in France to the foreign parent, and also on the distribution by the foreign parent at its seat, whether in the United Kingdom, the Netherlands, Italy, or possibly another country, they did not want a unilateral solution. They insisted on reaching a bilateral agreement that could be used in settling claims vis à vis these governments.

A. *Solution To Avoid Extraterritorial Taxation*

The French administrator explained that they believed that American and other foreign countries were charging the French subsidiary so high a price that it could not realize the profit to which it was entitled. We suggested the application of section 45 of the U.S. Revenue Act of 1928.¹⁷ After weeks of negotiating, we agreed to having the American mother and the French daughter company make a joint declaration of income allocated to the French subsidiary by dealings on an arms-length basis. This formality was later dropped.

The principle of territoriality would apply where the U.S. corporation was subject to the French dividend tax by reason of having a branch in France. We treated the branch as an independent entity and assumed that it would not distribute more than $\frac{3}{4}$ of its net income, which would be taxable as a dividend. Under the revised treaty of 1967,¹⁸ the U.S. corporation with a branch in, say Paris, bears the profits tax of 50% on the profits of the branch, and the dividend tax of 15% on a basis which is not to exceed $\frac{2}{3}$ of the net profit. This makes an effective rate of 55% on the net profit of the branch, as compared with an effective rate of 52.5% on the dividend *actually* distributed, which would include any profit which the French officials could prove to have been diverted by dealings not on an arm's length basis. The 1967 treaty envisages cooperation between the competent authorities of the two governments, who, under article 25, may get together to settle any dispute over the allocation of taxable income.

In the original negotiation of the treaty during the spring and summer of 1930, the French administrator of direct taxes wanted the United States to exempt from the U.S. withholding tax, copyright royalties paid by publishers in New York to French authors. We agreed, provided the reciprocal exemption at source would apply as well to royalties for the use of patents and know-how. This exemption was provided in the text, signed April 27, 1932,¹⁹ and was continued through revisions of the treaty until 1967 when

17. This section has now become §482 of the INT. REV. CODE of 1954, 26 U.S.C.A. §482 (1967).

18. Double Taxation: Taxes on Income and Property, July 28, 1967 [1967], 19 U.S.T. 5280, T.I.A.S. No. 6518.

19. Double Taxation: France, April 27, 1932, 49 Stat. 3145 (1932), T.S. No. 885 (terminated).

the French estimated that there was a larger amount of royalties on patents flowing from France to U.S. licensors than in the reverse direction. Hence, their negotiators insisted on introducing a withholding rate of 5% on royalties on patents flowing to American licensors, but maintained the exemption at source for copyrights to satisfy French authors.²⁰

When negotiating the first treaty with France in 1930, we used as a model, draft convention 1(b) which we had introduced at the Geneva Conference of 1928. After 1930, the French negotiators wanted a broader convention, which was negotiated in 1939.²¹ Synchronously, negotiations were going on with Sweden, resulting in a convention of 1939, which provided exemption at source for royalties and all kinds of interest, and a withholding rate of 10% for dividends covering the income tax as well as the Swedish property tax on shares.²²

B. *The Mexico Conference—Origins Of The U.S.-Canada Treaty*

Then came the treaty with Canada, the negotiation of which was begun in 1940 by the representative of Canada, Hon. C. Fraser Elliott, Deputy Minister of Internal Revenue for Canada, and Eldon P. King, Deputy Commissioner of Internal Revenue, for the United States, while attending a League of Nations Regional Tax Conference in Mexico City. This was arranged by the League Fiscal Committee of which I was Chairman. It melded into one text, the three Geneva draft conventions of 1928 with the model on allocation for tax purposes of business income which resulted from the survey of taxes and allocation methods in some 35 countries around the world that I had conducted as Director for the Fiscal Committee, 1931-1933.²³

The convention with Canada, signed in 1942,²⁴ settled questions of allocation of items of income and expense along a border of 3,000 miles, as well as exemption of Canadian residents from liability to the U.S. tax on capital gains from buying and selling securities on exchanges in New York, or elsewhere in the United States, and from U.S. tax on dividends distributed by Canadian companies out of income from U.S. sources.

In 1945, Mr. King flew to London in a war plane to negotiate a treaty²⁵ with the United Kingdom which would settle pending U.S. claims for tax

20. Double Taxation: Taxes on Income and Property, July 28, 1967 [1967], art. 11, 19 U.S.T. 5280, T.I.A.S. No. 6518.

21. Double Taxation: Income, July 25, 1939, 59 Stat. 893 [1945], T.S. No. 988 (effective January 1, 1945).

22. Double Taxation; Income, Mar. 23, 1939, art. VI and VII, 54 Stat. 1759 [1939], T.S. No. 958 (effective January 1, 1940).

23. See, M. Carroll, *Evolution of U.S. Treaties to Avoid Double Taxation*, 3 INT'L LAWYER 703-07 (1968).

24. Double Taxation: Income, Mar. 4, 1942, 56 Stat. 1399 [1942], T.S. No. 983 (effective January 1, 1941).

25. Treaty with United Kingdom on Double Taxation, April 16, 1945, 60 Stat. 1377 [1946], T.I.A.S. No. 1546 (effective January 1, 1945).

on capital gains on U.S. exchanges and encourage the availability of American capital by providing for the allowance by the United States of a credit for the U.K. tax which was added to dividends (art. VI).²⁶ It provided also for the exemption at source, on a reciprocal basis, of interest (art. VII) and royalties (art. VIII) from the British standard rate of tax.

C. Treaty Status Achieved Since 1945—Dividends

With the signing of the United Kingdom convention on April 16, 1945, the United States had, as guides for future negotiations, the initial treaty with France of April 27, 1932, and the more complete convention signed July 25, 1939. It had also the very complete convention with Sweden of March 23, 1939, and that with Canada, signed March 4, 1942. Also, during an interlude in the London negotiations, Mr. Eldon P. King, the chief negotiator for the United States, had managed to conclude a treaty with the Union of South Africa.²⁷ Applicable to income arising on and after July 1, 1946 (art. XVIII), the treaty was of limited scope but fairly standard.

With the foregoing treaties as a background, Mr. King and his associates began a round of negotiations with European countries. A pattern of 15% in general, and 5% for dividends from subsidiaries, which had emerged in these previous treaties,²⁸ was followed in a series of treaties with Denmark,²⁹ New Zealand,³⁰ Switzerland,³¹ and Finland.³²

26. This provision overcame the effect of a decision of the United States Supreme Court. See *Biddle v. Commissioner*, 302 U.S. 573, 58 S.Ct. 379, 82 L.Ed 431 (1938).

27. *Double Taxation: Income*, Dec. 13, 1946 [1946], 3 U.S.T. 3792, T.I.A.S. No. 2510.

28. When Swedish officials were negotiating the 1939 Convention (see note 22, *supra*), they wanted the effective foreign rate on dividends to be limited to 5%. Although the United States had adopted the 5% rate vis a vis Canada for dividends from a subsidiary in Canada, it would not go below 10% in the case of a noncontiguous country such as Sweden. The rates in the treaty with Sweden have since been changed to 15% in general and 5% if a U.S. corporation, for example, owns 10% of the Swedish company's stock. See *Double Taxation: Taxes on Income*, October 22, 1963 [1963], art. IA, 15 U.S.T. 1824, T.I.A.S. No. 5656.

In the intervening years, the Canadian withholding rate has been raised in the treaty to 15%. Likewise, the 1966 Supplementary Protocol with the United Kingdom places a reciprocal limitation of 15%, provided that the holding giving rise to the dividends is not effectively connected with a permanent establishment in the country where the dividends are paid. *Double Taxation: Taxes on Income*, Mar. 17, 1966 [1966], art. VI(5), 17 U.S.T. 1254, T.I.A.S. No. 6089.

In order to attract investments by U.S. corporations in Dutch companies, the Netherlands, at first in 1948, waived its tax on dividends (*Double Taxation: Income*, April 29, 1948, art. VIII, 62 Stat. 1757, T.I.A.S. No. 1855), but in 1965, it fixed the rate at not over 5% for investments in a 25%-owned subsidiary deriving mainly operating income. *Double Taxation: Taxes on Income*, Dec. 30, 1965 [1965], 17 U.S.T. 896, T.I.A.S. No. 6051. Otherwise, the withholding rate was limited to 15%. *Id.* at art. VII.

29. *Double Taxation: Income*, May 6, 1948 [1948], art. VI, 62 Stat. 1730, T.I.A.S. No. 1854.

30. *Double Taxation: Income*, March 16, 1948 [1951], art. VI, 2 U.S.T. 2378, T.I.A.S. No. 2360.

31. *Double Taxation: Income*, May 24, 1951 [1951], art. VI, 2 U.S.T. 1751, T.I.A.S. No. 2316.

Belgium first signed a treaty in 1948,³³ but in 1970 placed on the tax on dividends a limitation of 15%, provided the recipient has no local permanent establishment with which the dividends are effectively connected.³⁴

Norway, in a new treaty of 1971, limited the rate on dividends in general to 15% and on intercorporate dividends to 10%.³⁵

Greece, in 1950, omitted the article on dividends in view of the unusual structure of its income tax.³⁶

In a 1953 treaty with the United States, Australia lowered its withholding rate from dividends to 15% in order to obviate, if possible, an excess over the credit for the amount by which the effective rate of the Australian taxes on profits and dividends exceeded the U.S. effective rate.³⁷

Japan, in the convention with the United States signed March 8, 1971, limited the withholding tax on dividends to 15% of the amount actually distributed, and to 10% of the gross amount actually distributed if the recipient U.S. corporation owns 10% of the voting stock of a Japanese operating company.³⁸

Germany modified its treaty of July 22, 1954³⁹ by a protocol, signed September 17, 1965.⁴⁰ Accordingly, a resident corporation of the United States will not bear a rate in excess of 15% of the gross amount of the dividends received from a German company. However, if the U.S. corporation owns at least 10% of the voting stock, the rate may be increased to 25% of that part of any dividend which is deemed to be reinvested. This applies only if, at the time the dividend is distributed, the Federal Republic of Germany imposes a corporation tax on the distributed profit of the German company at a rate at least 20 percentage points lower than the corporation tax imposed upon its distributed profits. There is another limitation; if a transfer to the German company exceeds 7.5% of the dividends received by the U.S. corporation in the calendar year, the rate is increased to 25% on the portion of the dividend that is deemed to be reinvested, *i.e.*, amounts transferred to the German company by a U.S.

32. Double Taxation: Income, March 3, 1952 [1952], art. 12, 2 U.S.T. 2303, T.I.A.S. No. 2596.

33. Double Taxation: Income, October 28, 1948 [1953], 4 U.S.T. 1647, T.I.A.S. No. 2833.

34. Double Taxation: Taxes on Income, July 9, 1970 [1971], art. X, 23 U.S.T. 2687, T.I.A.S. No. 7463.

35. Double Taxation: Taxes on Income and Property, December 3, 1971 [1971], art. VIII, 23 U.S.T. 2832, T.I.A.S. No. 7474.

36. Double Taxation: Income, February 20, 1950 [1953], art. IX, 5 U.S.T. 47, T.I.A.S. No. 2902.

37. Double Taxation: Income, May 14, 1953 [1953], art. VII, 4 U.S.T. 2274, T.I.A.S. No. 2880.

38. Double Taxation: Income, March 8, 1971 [1973], art. XII 2(a), 23 U.S.T. 967, T.I.A.S. No. 7365.

39. Double Taxation, Taxes on Income, July 22, 1954 [1954], 5 U.S.T. 2768, T.I.A.S. No. 3133.

40. Double Taxation, Taxes on Income, September 17, 1965 [1965], 16 U.S.T. 1875, T.I.A.S. No. 5920.

corporation in excess of 7.5% of the dividends.⁴¹

In 1955, Italy reduced its withholding rate to 15% in general and to 5% for dividends from a subsidiary.⁴²

The treaty with Luxembourg in 1962⁴³ followed the example set by the Austrian treaty of 1956, which placed a ceiling of half the statutory rate in general, provided that the rate shall not exceed 5% where the recipient is a controlling corporation and the subsidiary is an operating company.⁴⁴

In other treaties, Pakistan agreed to reduce its supertax on dividends, subject to certain conditions,⁴⁵ and Trinidad-Tobago applied a rate of 10% to dividends and branch profits in addition to the profits tax.⁴⁶

D. Countries Exempting, Or Reducing Tax On Interest

A primary reason for the eagerness of the British government to conclude a tax treaty in 1945 with the United States was to provide, on condition of reciprocity, for source exemption of interest on much needed post-war rehabilitation loans to British companies. The United Kingdom, in 1945,⁴⁷ went all the way by agreeing to give up its tax, on a reciprocal basis, under certain conditions, and in the supplementary protocol of 1966,⁴⁸ introduced the conditions that the U.S. resident, for example, has in the United Kingdom no permanent establishment with which the interest is effectively connected. This provision is not to apply if the interest is treated as a distribution.⁴⁹

The subject was not considered in our 1932 treaty with France,⁵⁰ but a 10% tax limitation was introduced in the convention with France signed in 1939,⁵¹ and was continued in that of 1967.⁵²

41. *Id.* at art. VI.

42. Double Taxation: Income, March 30, 1955 [1956], art. VII, 7 U.S.T. 2999, T.I.A.S. No. 3679.

43. Double Taxation: Taxes on Income and Property, December 18, 1962 [1964], art. IX, 15 U.S.T. 2355, T.I.A.S. No. 5726.

44. Double Taxation: Taxes on Income, October 25, 1956 [1957], art. VI, 8 U.S.T. 1699, T.I.A.S. No. 3923.

45. Double Taxation: Taxes on Income, July 1, 1957 [1959], art. VI, 10 U.S.T. 984, T.I.A.S. No. 4232.

46. Double Taxation: Taxes on Income, January 9, 1970 [1970], art. 12, 22 U.S.T. 164, T.I.A.S. No. 7047.

47. Treaty with United Kingdom on Double Taxation, April 16, 1945 [1945], 60 Stat. 1377, T.I.A.S. No. 1546.

48. Double Taxation: Taxes 48. Double Taxation: Taxes on Income, March 17, 1966 [1966], 17 U.S.T. 1254, T.I.A.S. No. 6089.

49. The essence of this provision was followed by Ireland. Double Taxation: Income, September 13, 1949 [1951], art. VII, 2 U.S.T. 2303, T.I.A.S. No. 2356.

50. Double Taxation. France, April 27, 1932 [1935], 49 Stat. 3145, T.S. No. 885 (terminated).

51. Double Taxation: Income, July 25, 1939 [1945], 59 Stat. 893, T.S. No. 988 (effective January 1, 1945).

52. Double Taxation: Taxes on Income and Property, July 28, 1967 [1967], art. X, 19 U.S.T. 5280, T.I.A.S. No. 6518. The Treaty reduced the withholding rate from 15% to 10%.

The Swedish government set a pattern by providing, in its treaty of 1939,⁵³ and more specifically in 1963,⁵⁴ for collecting no withholding rate at source, assuming the creditor in the United States, for example, has permanent establishment in the debtor's state, *e.g.*, Sweden.

Canada and the United States, in the treaty of 1942, agreed to the rate of 15%, which was already applicable in Canada, assuming the creditor has no permanent establishment in the borrower's country.⁵⁵

The Netherlands, in 1948,⁵⁶ initially followed the British example, but amended the article in 1965⁵⁷ by conditioning the exemption on the indebtedness not being effectively connected⁵⁸ with a permanent establishment, and to the extent it represented fair and reasonable consideration for the loan.

Greece conditions the exemption at source on grounds of reciprocity, provided the rate does not exceed 9% per annum and the Greek corporation is not controlled through ownership of more than 50% by the creditor corporation.⁵⁹

Germany, in its treaty of 1954, as amended in 1965,⁶⁰ reciprocally exempts interest at source provided that the U.S. creditor has no permanent establishment⁶¹ in Germany with which the interest is effectively connected, and that the rate conforms to that which would prevail between unrelated persons.

Under similar conditions, Belgium withholds 15% reciprocally;⁶² Switz-

provided that the indebtedness is not effectively connected with a permanent establishment of the creditor in the state of the debtor.

Likewise, interest is reciprocally exempt, on the condition that the nonresident creditor has no permanent establishment in the borrower's country in treaties with Denmark, Double Taxation: Income, May 6, 1948 [1948], art. VII, 62 Stat. 1730, T.I.A.S. 1854; Finland, Double Taxation: Income, March 3, 1952 [1952], art. 13, 2 U.S.T. 2303, T.I.A.S. No. 2596; and Luxembourg, Double Taxation: Taxes on Income and Property, December 18, 1962 [1964], art. VIII, 15 U.S.T. 2355, T.I.A.S. No. 5726.

53. Double Taxation: Income, March 23, 1939 [1940], 54 Stat. 1759, T.S. No. 958.

54. Double Taxation: Taxes on Income, October 22, 1963 [1963], art. VIII, 15 U.S.T. 1824, T.I.A.S. No. 5656.

55. Double Taxation: Income, March 4, 1942 [1941], art. XI, 56 Stat. 1399, T.S. No. 983.

56. Double Taxation: Income, April 29, 1948 [1947], art. VIII, 62 Stat. 1757, T.I.A.S. No. 1855.

57. Double Taxation: Taxes on Income, December 30, 1965 [1967], art. VI 17 U.S.T. 896, T.I.A.S. No. 6051.

58. The "effectively connected" test was added by Norway in 1949, Double Taxation: Income, June 13, 1949 [1951], art. 9, 2 U.S.T. 2323, T.I.A.S. No. 2357.

59. Double Taxation: Income, February 20, 1950 [1953], art. VI, 5 U.S.T. 47, T.I.A.S. No. 2902.

60. Double Taxation: Taxes on Income, September 17, 1965 [1965], art. VII, 16 U.S.T. 1875, T.I.A.S. No. 5920.

61. The treaty with Austria also conditions the exemption on the absence of a permanent establishment. Double Taxation: Taxes on Income, October 25, 1956 [1957], art. VII, 8 U.S.T. 1699, T.I.A.S. No. 3923.

62. Double Taxation: Taxes on Income, July 9, 1970 [1971], art. 11, 23 U.S.T. 2687, T.I.A.S. No. 7463.

erland withholds its coupon tax on 5%, provided the creditor is not a Swiss citizen;⁶³ Japan limits its rate to 10% provided the creditor's interest is not effectively connected with an establishment in Japan;⁶⁴ and Trinidad-Tobago places a limit of 15% on interest received by a U.S. bank not having a permanent establishment in its territory.⁶⁵

Interest is now covered in the U.S. treaties with the Union of South Africa, New Zealand, Australia, Italy, and Pakistan.

E. Patent And Copyright Royalties Reciprocally Exempted In General

In 1930, when we were negotiating our first treaty with France, the director of the French Bureau of Direct Taxes was most insistent on the U.S. agreeing to waive its withholding rate withheld from copyright royalties paid to French authors. However, at our instance the exemption at source⁶⁶ covered not only royalties for the use of copyrights, but also patents, secret processes and formulae, trademarks, and similar rights. In negotiating the present convention of 1967, the French took note of the fact that the flow of industrial royalties to the United States was greater than that to France and insisted on adopting a rate of 5% on royalties paid for the use of patents and other industrial property. However, copyright royalties continued to be exempt.⁶⁷

In the 1951 convention, Canada agreed to waive the 15% withholding tax on copyright royalties, provided the recipient has no permanent establishment in Canada,⁶⁸ but continued it for patent royalties.⁶⁹

In 1945, Britain was eager to encourage the inflow of American technology to recondition its industries hurt by World War II. It granted, reciprocally, an exemption from its withheld standard rate of tax, provided the U.S. recipient was not engaged in trade or business in its territory.⁷⁰ When

63. Double Taxation: Income, May 24, 1951 [1951], art. VII, 2 U.S.T. 1751, T.I.A.S. No. 2316.

64. Double Taxation: Income, March 8, 1971 [1973], art. 13, 23 U.S.T. 967, T.I.A.S. No. 7365.

65. Double Taxation: Taxes on Income, January 9, 1970 [1970], art. 13, 22 U.S.T. 164, T.I.A.S. No. 7047.

66. Double Taxation: France, April 27, 1932 [1935], art. 7, 49 Stat. 3145, T.S. No. 885 (terminated).

67. Double Taxation: Taxes on Income and Property, July 28, 1967 [1967], art. 11, 19 U.S.T. 5280, T.I.A.S. No. 6518.

68. Double Taxation: Income, January 12, 1950 [1951], art. XIII, 2 U.S.T. 2235, T.I.A.S. No. 2347.

69. *Id.* at art. XI.

70. Treaty with United Kingdom on Double Taxation, April 16, 1945 [1946], art. VIII, 60 Stat. 1377, T.I.A.S. No. 1546. The supplementary protocol of 1966 adds the "effectively connected" test and excludes a corporation owning more than 50% of the voting power of the business. Double Taxation: Taxes on Income, March 17, 1966 [1966], art. VIII 3-4, 17 U.S.T. 1254, T.I.A.S. No. 6089.

Ireland initially followed the U.K. example. Double Taxation: Income, September 13, 1949 [1951], art. VIII, 2 U.S.T. 2303, T.I.A.S. No. 2356.

it was discovered that the wording would eliminate the exemption if the U.S. corporation had a sales office in London which had no connection with the license agreement, a Protocol was negotiated in 1956 which prevented the application to the unrelated branch, if the royalties were not directly associated with the business carried on through the permanent establishment.⁷¹

In 1948, New Zealand agreed to allow a U.S. resident, for example, deriving royalties of any type, to elect to be taxed on a net basis as if engaged in trade at a permanent establishment in the licensee's country.⁷²

The Norwegian treaty of 1949 provides for reciprocal exemption but denies the deduction of any part of the royalty which they do not consider to be reasonable consideration for the right to use the property.⁷³

Australia, in 1953, exempted at source only copyright royalties (but not for motion picture films), provided the licensor has no permanent establishment in the country of the licensee.⁷⁴

In 1954, Japan limited its withholding to 15%, but in 1962 lowered the rate to 10% for both patent and copyright royalties under essentially similar conditions.⁷⁵

Italy exempts royalties for copyrights, patents, etc., from the national tax, but not local taxes.⁷⁶

Austria, in 1956, adopted the general terms for reciprocal exemption,⁷⁷ as did Pakistan in 1957,⁷⁸ and Luxembourg in 1962.⁷⁹

The 1954 treaty between Germany and the United States, perhaps inspired by the article in the convention of the OECD, contains refinements, such as including in the definition royalties for the use of skill and know-how, and adds gains derived from the alienation of any right or property.

71. Double Taxation: Taxes on Income, August 19, 1957 [1956], art. I, 9 U.S.T. 1329, T.I.A.S. No. 4124.

72. Double Taxation: Income, March 16, 1948 [1951], art. VII, 2 U.S.T. 2378, T.I.A.S. No. 2360.

73. Double Taxation: Income, June 13, 1949 [1951], art. 10, 2 U.S.T. 2323, T.I.A.S. No. 2357. Similar provisions were adopted by Greece, Double Taxation: Income, February 20, 1950 [1953], art. VII, 5 U.S.T. 47, T.I.A.S. No. 2902 and Switzerland, Double Taxation: Income, May 24, 1951 [1951], art. VIII, 2 U.S.T. 1751, T.I.A.S. No. 2316. Finland adopted a similar exemption for copyright royalties. Double Taxation: Income, March 3, 1952 [1952], art. 14, 2 U.S.T. 2303, T.I.A.S. No. 2596.

74. Double Taxation: Income, May 14, 1953 [1953], art. X, 4 U.S.T. 2274, T.I.A.S. No. 2880.

75. Double Taxation: Taxes on Income, August 14, 1962 [1966], art. 14, 16 U.S.T. 697, T.I.A.S. No. 5798.

76. Double Taxation: Income, March 30, 1955 [1956], art. VIII, 7 U.S.T. 2999, 3007-08, T.I.A.S. No. 3679.

77. Double Taxation: Taxes on Income, October 25, 1956 [1957], art. VIII, 8 U.S.T. 1699, T.I.A.S. No. 3923.

78. Double Taxation: Taxes on Income, July 1, 1957 [1959], art. VII, 10 U.S.T. 984, T.I.A.S. No. 4232.

79. Double Taxation: Taxes on Income and Property, December 8, 1962 [1964], art. VII, 15 U.S.T. 2355, T.I.A.S. No. 5726.

Moreover, the exemption will not apply if the licensor has a permanent establishment with which the right or property is effectively connected. If a royalty exceeds the amount that would be agreed upon by independent parties, the excess is excluded from the exemption.⁸⁰

The Trinidad-Tobago Treaty of 1970 provides for reciprocal exemption of literary and artistic royalties, but industrial royalties are subject to a maximum rate of 15%.⁸¹

IV. TNCs WITH AFFILIATES IN FRANCE, BRITAIN, GERMANY, AND JAPAN

Since we are concerned mainly with corporations organized in the United States which expand their activities through subsidiaries overseas, let us take, as an example, the situation of a transnational corporation with its head office in New York City, which has affiliates in the four outstanding "home countries," namely France, Britain, Germany, and Japan.

All four of these countries have offered inducements in their tax laws and treaties for their domestic corporations to organize affiliates abroad. They also seek to attract foreign-based TNCs to establish local affiliates, or headquarters, for operations in their territories or in third countries, and we have shown how these countries have, in treaties, reduced their rates on dividends and reduced or waived their rates at source on interest and royalties.

Thanks to the existence of treaties concluded by the United States with all four of these countries, the effective rate of taxes on the affiliates' profit, before and after distribution in one country, may be averaged with rates reduced or waived on interest and royalties in that country or other treaty countries. This is done under the overall limitation on the foreign tax credit with the result that the credit, limited by the U.S. top corporate rate of 48%, may cover the credits for all the taxes on income from the four affiliates.⁸²

All of these countries allow credits to their corporations in respect of income earned and taxed in third countries. However, the scope of the U.K. credit was restricted by the introduction of the Advance Corporation Tax (A.C.T.) in 1973,⁸³ so that the amount of the credit for non-British taxes has been reduced to around 19%. Hence, it is not recommended that a U.S. corporation have a company in the United Kingdom hold shares in

80. Double Taxation: Taxes on Income, July 22, 1954 [1954], art. VIII, 5 U.S.T. 2768, T.I.A.S. No. 3133. Essentially similar amendments have been inserted in the Supplementary Convention with the Netherlands, Double Taxation: Taxes on Income, December 30, 1965 [1967], art. VII, 17 U.S.T. 896, T.I.A.S. No. 6051 and the Supplementary Protocol with the U.K., Double Taxation: Taxes on Income, March 17, 1966 [1966], art. 7, 17 U.S.T. 1254, 1259-60, T.I.A.S. No. 6089.

81. Double Taxation: Taxes on Income, January 9, 1970 [1970], art. 14, 22 U.S.T. 164, T.I.A.S. No. 7047.

82. See §§901-05 of the INT. REV. CODE of 1954, 26 USCA §§901-05.

83. I. GUIDES TO EUROPEAN TAXATION, *United Kingdom*, 1-6 (March, 1975).

affiliates in third countries.

Nevertheless, we will examine briefly the regimes in those countries for corporations that extend their activities into third countries and could be regarded as TNCs.

A. France As A Base For A TNC

A company organized in France and having its seat there, whether it is a subsidiary of a U.S.-based TNC or qualifies independently as a French TNC, is subject to the French company tax, in principle, only with regard to income earned, or deemed to have been earned, in France. Accordingly, the French company is not taxable in that country on income it derives through a permanent establishment or representative in another country, or through completing abroad a cycle of commercial activity.⁸⁴

A resident company may elect, with the approval of the authorities, to pay tax on the basis of world-wide income, including that derived through permanent establishments or subsidiaries abroad. Similar to the relief in U.S. law, credit is allowed against the French tax for the income and withholding taxes paid abroad. In computing taxable income, deductible items include interest and royalties, the local *patente* tax, and taxes on turnover and payroll.

The company income tax has a normal rate of 50%. Longterm capital gains are subject to reduced rates, such as 25% on the sale of a building site and 15% on other long-term gains, as well as gains from the sale of patent rights.

In addition to the company income tax, a *precompte* of 50% is levied on the net distribution of income of accounting years which end more than five years before distribution of income which is not subject to the company income tax at the normal rate of 50%. These items include exempt income from foreign sources or exempt dividends received from a domestic or foreign subsidiary. When the income distribution consists of dividends received from a domestic subsidiary, the *precompte* is offset by the special tax credit (*avoir fiscal*) granted on receipt of such dividends. No *precompte* is due with respect to foreign source income when the company has elected to be taxed on world-wide income, inasmuch as the foreign income has been fully subject to the company income tax.⁸⁵

84. See I GUIDES TO EUROPEAN TAXATION, *France*, 1-4 (March, 1975). The French company's taxable income includes dividends, interest, and royalties from foreign and domestic sources, by virtue of an exception to the principle of exempting income from foreign sources.

85. The *precompte*, under tax treaties, is refunded to non-resident corporate shareholders who are not entitled to the credit for *avoir fiscal*. If no such treaty provision exists, the non-resident corporate shareholder may apply for a refund of the *precompte*. See I INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *France*, 1-2 (1966).

The special tax credit for *avoir fiscal*, equal to 50% of the dividend received from resident companies, is granted to resident individual and corporate shareholders. The amount of the credit is first included in taxable income and the tax due, with respect to the grossed-up dividend, is subsequently reduced by the same amount.

A French TNC qualifies as a "parent" company if it holds at least 10% of the shares of a "subsidiary," whether organized in France or in a foreign country. A "parent" company excludes dividends received from its income subject to the French company tax, except 5% which is deemed to cover expenses allocable to holding the shares. If a company does not qualify as a "parent" company, it includes dividends in its taxable income subject to treaty provisions for the allowance of credits.

Non-residents Taxable by Withholding at Source

Dividends, paid by a French company to non-resident shareholders, are taxable under French law by withholding 25%,⁸⁶ but this rate is reduced by the U.S.-France treaty in general to 15%, but to only 5% of the amount *actually* distributed if the recipient U.S. corporation owns at least 10% of the voting stock of the French company, and if it was previously an operating company.⁸⁷ The word "actually" is used to cover diverted profits when not declared as dividends.

Interest and Royalties

Generally, the interest paid by a French company to a U.S. corporation enjoys the reduction of the withholding rate of 25% to 10% in the case of interest on bonds, notes, debentures, or any other form of indebtedness from sources in France.⁸⁸

Royalties from French sources, paid to non-resident individuals or companies, are subject to withholding of 24% on 80% of the royalties (the 20% representing expenses), making an effective rate of 19.2%. This rate is reduced by the French-U.S. treaty to 5% for royalties on patents and the like, but copyrights of literary, artistic, or scientific works are exempt at source.⁸⁹

U.S. Company with a Branch in France

A non-resident corporation with a branch in France is subject to the company tax on its net profit and also to the tax on income from securities on the basis of a presumed dividend. Prior to the conclusion of our first treaty with France, this was computed in the same proportion as dividends, distributed at the home office as assets or business in France, bore to the total assets or business. In the initial treaty of 1932,⁹⁰ this basis was

86. See I GUIDES TO EUROPEAN TAXATION, *France*, 11-13, 34 (1965).

87. Double Taxation: Taxes on Income and Property, July 28, 1967 [1967], art. 9(2)(b), 19 U.S.T. 5280, T.I.A.S. No. 6518.

88. However, if the bonds were issued before January 1, 1965, the interest may be taxed at a rate not in excess of 12%. *Id.* at art. 10.

89. *Id.* at art. 11.

90. Double Taxation: France, April 27, 1932 [1935], 49 Stat. 3145, T.S. No. 885 (terminated).

limited to $\frac{3}{4}$ of the net profit of the branch as determined for the profits tax. The 1967 treaty with France provides for reducing the base to $\frac{2}{3}$ and limiting the rate to 15%.⁹¹ This makes an effective rate of 55% on the amount presumed to be distributed, and compares with an effective rate of 52½% on dividends distributed by a subsidiary. The difference is a factor in favor of operating in France through a subsidiary rather than a branch.

French Holding Company

If the U.S.-based TNC has a French holding company, when dividends are paid under the French treaty with the given third country, they may bear a higher dividend tax rate than that paid on upstream dividends from a 10%-owned subsidiary under the U.S. treaty with that country.

The American enterprise can have the benefits of the U.S. law by holding directly shares in the non-French companies and getting the full potential credit for foreign taxes with a minimum, if any, of excess credits. At the same time, it may have a U.S. subsidiary with a headquarters branch in France which will be taxed on a minimal basis. Personnel at this headquarters branch can supervise and coordinate the activities of the U.S. parent's operating subsidiaries in other countries and also coordinate them with the principal office and other units in the United States. This should cost far less in taxes and other expenses as the result of the supervisory staff being based primarily in New York City rather than in France. In that way, the U.S.-based TNC with a headquarters branch in Paris can have the advantages of a conveniently located Paris center with ready access to London, Brussels, Frankfurt, Geneva, Zurich, and Milan.

French Inducements for Bases of TNCs

The French government is now actively endeavoring to outdo Brussels and London in attracting a base for a TNC operating not only in France, but also in one or more of the eight other countries of the Common Market.⁹² It could also provide a basis for activities in countries in the European Free Trade Area, the Mediterranean region, and even Asia, Africa, and the Far East!

With regard to France itself, the head of DATAR, the regional development agency of the French government, declared that France welcomes foreign investment when it helps to improve the balance of payments,

91. Double Taxation: Taxation on Income and Property, July 28, 1967 [1967], art. 13(2)(a), 19 U.S.T. 5280, T.I.A.S. No. 6518.

92. Previously, Britain, Belgium, and Switzerland invited the establishment of headquarters of foreign companies; France was restrictive. Recently, however, the former have tightened their taxes and restrictions on resident foreign executives, but France is now seeking to induce international enterprises to establish their headquarters of liaison offices in Paris or other convenient French cities.

creates employment in areas with surplus manpower, and brings in new technical knowledge. DATAR will assist in the selection of a plant site, cooperate with other administrative bodies in negotiating financial incentives, and participate in meetings of the Committee for Foreign Investment. The government has adopted measures to lighten the administrative procedures and clarify the tax regime in favor of placing a European Headquarters in Paris, or in a relatively convenient city such as Lyon, Nice, or Strasbourg.

Acquisitions by a foreign-based TNC of existing French companies are examined on a case-by-case basis by the Committee on Foreign Investments to determine the advantage of the investment to France. That body wants to know if, after the takeover, the enterprise will subsequently maintain in France: research and development, the export potential, or the decision making center.⁹³

Empirical Basis for a TNC's Headquarters in France

The French authorities have been said to agree to tax a headquarters office on a presumed taxable income of 8% of expenses, which will bear the normal rate of 50%, making an effective rate of 4%, plus a putative dividend tax of 5%.⁹⁴ France recognizes that large international enterprises, established in numerous countries, especially European, are induced to coordinate the different establishments which they control by installing headquarters in each region of the world. It appears necessary to coordinate their tax regimes.

In a note, the French authorities have defined a headquarters (*quartier general*) as a fixed installation of an international enterprise or a group of enterprises. The relations between the headquarters and the enterprise vary. The headquarters may be constituted by a company, or what is called a group of economic interests, or a simple permanent establishment. The headquarters acts exclusively for the account of the enterprises of the group. If it furnishes services to third enterprises, the income earned would be subject to ordinary rules of taxation.

The activities of the general headquarters consist in rendering services corresponding to the functions of direction, management, coordination, and control. These services are different from those of the establishment of production, purchasing, or exploitation, which have no power of impulsion or coordination over other units in the group.

The French note says that a headquarters is distinguishable from a "liaison bureau" (*bureau de liaison*), established by a foreign enterprise, for example, in France. Such a bureau has the exclusive purpose of gathering information, supplying instructions, making publicity, or conducting

93. I GUIDES TO EUROPEAN TAXATION, *France*, 1-4 (March 1975).

94. XXIX INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, No. 7, 293 (July/August 1975).

scientific research for the account of foreign companies. They have, in effect, only an auxiliary or preparatory activity under various tax conventions. The competence of a headquarters is limited to a geographic sector. It cannot make decisions with regard to the entire group.

Competent Tax Administration in France

In the French fiscal administration there is a "Department of Foreign Companies" which is charged with receiving, informing, and orienting representatives of foreign companies which wish to install a European headquarters in France. After examining the facts, this office will determine the applicable tax regime and assure the control in conjunction with the interested regional office. The regular supervision of documents will be conducted by territorial directions with regard to the assessment, the receipt of declarations, and the payment of the tax. Under these conditions, the directors of taxation will submit problems relating to a headquarters to the department of foreign companies. The files (*dossiers*) will be sent to this department with pertinent explanations.⁹⁵

Other Incentives

To attract manufacturing and research, France gives cash grants, various tax reliefs, subsidies for job training, and personnel moving and relocation expenses. The government seeks to induce companies to avoid the Paris area and locate plants in western, central, and southwestern France. Cash grants, ranging from 15% to 25%, are related to the amount of investment and the number of new employees.

B. Britain As A Base

A U.S.-based transnational corporation would become a "resident in the United Kingdom" if its central management and control were exercised there. A resident company is subject to the corporation tax on its entire amount of domestic and foreign taxable income and capital gains, subject to provisions for relief from double taxation in the U.K. laws and tax treaties with other countries.

The unilateral relief under U.K. law is by way of a credit against the company's British tax for the tax charged directly by a foreign country on

95. *Id.*

96. This "indirect credit" is enjoyed by a U.K. company holding at least 10% of the voting power in the foreign company and, under certain conditions, even if it holds less than 10%. It also covers tax paid by a sub-subsidiary to the extent that the tax would be creditable if the dividend had been paid by the non-resident company to the U.K. company. This credit applies as well to taxes paid by sub-sidiaries further removed along a chain of qualifying holdings of 10%, but only with regard to distribution of dividends grossed-up by the company tax thereon. The credit is limited by the amount of the U.K. tax on the grossed-up foreign income. See M. BURGE, *THE UNITED KINGDOM AS A JURISDICTION FOR A MULTINATIONAL HOLDING COMPANY*, AMERICAN MANAGEMENT ASSOCIATION, _____ (1974).

the income received, as well as for tax paid indirectly through a foreign subsidiary on the net profit from which a dividend is paid.⁹⁶

However, since the introduction of the Advance Corporation Tax (A.C.T.) in 1973,⁹⁷ this foreign tax credit may be restricted by the new system of taxing corporate profits and distributions. The reason for this is that the A.C.T., payable with respect to "qualifying distributions," also represents the minimum corporation tax payable on the profits so distributed. Consequently, if foreign profits, which have been subject to tax abroad, are distributed to shareholders, the scope of the foreign tax credit is in fact restricted to 19%, the difference between the 1975 corporation tax of 52% and the rate of advance corporation tax of 33%. The company may assume that its distributions are paid primarily out of fully taxed domestic income, and out of foreign income only insofar as distributions of profits exceed domestic source profits.

British companies that have long been in existence presumably know how to cope with the recently-introduced complexities in the tax law when they derive income from non-British as well as U.K. sources. On the contrary, U.S. corporations are inclined to avoid problems by using a British subsidiary only for operations in the United Kingdom; they would thus pay the British tax on their U.K. income.

The British company, under the A.C.T., does not withhold any tax from dividends paid to the U.K. parent. Under the U.K.-U.S. treaty of April 16, 1945, as amended, the rate on dividends paid to the U.S. parent was limited to 15% by article VI(2). However, this article has been modified in a treaty signed December 1, 1975 in view of the change in the U.K. law introducing the Advance Corporation Tax, which provides no withholding on intercompany dividends.⁹⁸

97. I GUIDES TO EUROPEAN TAXATION, *United Kingdom*, 1-6 (March 1975).

98. Treaty with United Kingdom on Double Taxation, April 16, 1945 [1946] 60 Stat. 1377, T.I.A.S. No. 1546, *amended by* Double Taxation: Taxes on Income, March 17, 1966 [1966] 17 U.S.T. 1254, T.I.A.S. No. 6089. Under the treaty of 1945, provided certain conditions are met, no tax is withheld at source from interest on bonds, securities, debentures, or other forms of indebtedness (art. VII). The same is true in regard to royalties (art. VIII).

Article 10 on dividends in the treaty with the United Kingdom, signed December 31, 1975 (but not yet ratified on January 30, 1976) provides that dividends, distributed by a U.K. company to a U.S. parent corporation, may be charged to a tax not exceeding 15 per cent of the gross amount of the dividends, subject to certain conditions. The first is that this limitation does not apply as long as an individual resident in the United Kingdom is entitled by law to a tax credit (e.g., under the ACT) in respect of dividends paid by a U.K. resident corporation. Instead, dividends paid by a British company to a U.S. parent corporation which either alone or together with one or more associated corporations controls, directly or indirectly, at least 10 per cent of the voting stock of said British company, the corporation shall be entitled to a payment from the United Kingdom of a tax credit equal to one-half of the tax credit to which an individual resident in the United Kingdom would have been entitled had he secured the dividend, subject to the deduction of an amount not exceeding 5 per cent of the aggregate of the dividend and the amount of the tax credit. (Otherwise, such as is the case of a corporation holding less than 10 per cent or an individual resident in the United States the deduction could not exceed 15 per cent of the dividend plus a credit equal to that which an individual resident in the United Kingdom would be entitled.)

U.S.-Based TNC with a U.K. Holding Company

It is obvious that the U.K. tax law does not encourage recourse by a U.S.-based TNC to hold, via a U.K. company, shares in subsidiaries in Common Market countries or other jurisdictions. A resident British company is taxable on its worldwide income, including dividends, interest, and royalties. Since the conclusion of the U.K.-U.S. Income Tax Convention of 1945, which embodies for U.S. taxpayers the American credit for foreign taxes, the United Kingdom has adopted a credit modeled largely on the former. However, in calculating the allowable credit, items of income from sources in each country are categorized by source, according to the nature of each activity which generates the profits. There is no combining of credits for taxes on income from difference sources, and nothing comparable to the U.S. per-country and overall limitations.⁹⁹

Moreover, liability for the A.C.T. is incurred by a British company which pays dividends to its non-resident U.S. shareholders. In ordinary circumstances, the company distributing the dividend can recover the A.C.T. against its own tax liability. As has been stated, the opportunity for set-off by a U.K. company with foreign source income is limited. The conclusion of an experienced member of a large accounting firm, who was formerly a U.K. inspector of taxes, is that the United Kingdom is not a favorable jurisdiction in which to have a local company hold investments in companies in third countries.¹⁰⁰

Britain as a Base for a Service Company

Some U.S. companies have found it convenient to organize, for example in Delaware, a subsidiary in the United States which registers a branch in London to render technical, legal, and financial assistance to affiliates located in more distant countries. Apart from the many non-tax advantages of being established in London, the Board of Inland Revenue in Somerset House on the Strand, has been known to agree to tax such a company on a presumed net income, computed on the basis of 5% of its service charges to other units of the international enterprise.

However, the aggregate of the dividend and the tax credit paid to the U.S. corporation or other resident in the United States (without reduction for the 5 or 15 per cent deduction) will be treated as a dividend for purposes of the U. S. credit for foreign taxes. The foregoing benefits are not enjoyable if the recipient in the United States has, in the United Kingdom, a permanent establishment with which the shareholding is effectively connected (art. 10(1) through 10(4)).

99. In computing the U.K. tax on foreign income, the net foreign income is grossed-up by adding back the amount of foreign tax paid with respect to such income. The gross foreign income is included in the taxable base and the foreign tax is then credited against the U.K. tax. These new limitations on the credit are said to discourage looking to Britain as a shelter for a company to hold shares in companies in third countries.

100. M. BURGE, *THE UNITED KINGDOM AS A JURISDICTION FOR A MULTINATIONAL HOLDING COMPANY*, AMERICAN MANAGEMENT ASSOCIATION, — (1974).

Moreover, Inland Revenue has, in some cases, agreed to a percentage of non-U.K. earned and investment income by arranging for payment of income and retention of the funds abroad. It is said that the American corporation that wishes to establish a base in London may, despite reports of recent tightening of the rules on tax liability for visiting foreigners, enter into an agreement with the British authorities on a reasonable basis which outlines rights and obligations. Presumably, the company's representatives who check in at the London branch will spend most of their time visiting their corporate employer's affiliates in continental European countries or elsewhere. Care must be taken not to become entangled in the meshes of subpart F of the U.S. Internal Revenue Code.¹⁰¹

C. Germany As A Base

U.S.-based TNCs have, in many cases, organized or acquired in West Germany, an *Aktiengesellschaft* (AG) or a *Gesellschaft mit beschränkte Haftung* (G.m.b.H.) to import and sell their products, or to import components and combine them with local materials or parts. The sales may be made to consumers in that country or in neighboring countries. Sometimes the U.S. corporation will license its patents or know-how to its subsidiary (or an unrelated company) and receive royalties. The U.S. corporation may lend capital to the local company against payment of interest.

Licensing Agreements

From the viewpoint of liability for the income tax, the most favorable way to start in Germany is to conclude a licensing arrangement with a local company. Royalties are exempt from the German withholding tax of 25% under the German-U.S. Income Tax Convention of 1954, as amended.¹⁰² However, they are subject to the turnover tax, generally with a rate of 11%. If the U.S. corporation, in order to assure a better utilization of its patents, acquires a stock interest in the licensee *Gesellschaft*, the German tax withheld from dividends is 25%. Under the treaty, this rate is reduced in general to 15% and if the U.S. corporation owns 10% or more of the stock, and brings home dividends from the German subsidiary for distribution to its shareholders or for use in the United States, the effective rate is 15%.¹⁰³

Registering a Branch in Germany

The U.S. corporation with a branch in Germany is not subject to a dividend tax, but is liable to the municipal or state trade tax (*Gewerbsteuer*), composed of rates on net income, net worth, and, in

101. See 26 U.S.C.A. §6001 *et seq.* (Rev. 1967).

102. Double Taxation: Taxes on Income, September 17, 1965 [1965], art. VIII, 16 U.S.T. 1875, T.I.A.S. No. 5920.

103. *Id.* at art. VI.

many cases, payroll.¹⁰⁴ These rates are multiplied by coefficients making a top effective rate which varies, according to the municipality, from 16 to 20 percent of taxable income; in addition there is a national tax on net worth of 1%. The trade tax is deductible from the branch's income, subject to the national corporation tax with a flat rate of 49%, plus a surcharge of 3%, making an effective rate of 50.47%.

Organizing a German Subsidiary

If the U.S. corporation acquires or organizes a subsidiary, whether a limited company, which is likened to an incorporated partnership (*Gesellschaft mit beschränkter Haftung*) (G.m.b.H.), or a corporation (Aktiengesellschaft, A.G.), it is subject like a branch to the trade tax.¹⁰⁵ If all the company's income can be distributed, *e.g.*, by using reserves to pay the tax, the effective rate will be around 23.26%. Obviously, companies are rarely in a position to do this and the effective rate will depend on the proportion distributed. In addition, the German company must withhold from the dividend the capital yield tax (*Kapitalertragsteuer*) of 25%. Nevertheless, if the U.S. corporation holds 10% or more of the voting stock in the German company, and does not reinvest the dividend in that company, the rate is 15%.¹⁰⁶

Considering only the income taxes on the German company and dividends, the effective rate can easily exceed the U.S. rate of 48%, which limits the U.S. credit for foreign taxes. However, if the U.S. corporation can include in its taxable income from sources in Germany, a sufficient amount of royalties and interest exempted at source, the effective rate on dividend income may be averaged with the zero rates on the other two categories so that the resulting rate will come within the limit of 48% on the credit.

The element of net worth in the trade tax and the national tax on net worth are not includible in German taxes allowable as credits against the U.S. income tax. This disadvantage may be offset by liberal allowances in computing net income and incentives offered by certain depressed areas in Germany that are seeking to attract investments.

Allowances for a German Company Operating in Third Countries

Ever since the first income tax convention, concluded on June 21, 1899 by Prussia with Austria-Hungary, the Germans have been leaders in reaching agreements for the avoidance of double taxation. In this 1899 treaty,

104. I GUIDES TO EUROPEAN TAXATION, *West Germany*, 3 (March 1975).

105. *Id.* at 1. However, it bears the corporation tax with split rates of 51% on undistributed income and 15% on distributed income. These rates are subject to a surcharge of 3%, making them respectively 52.53% and 15.45%. As the tax on distributed income is paid out of undistributed income, the amount of the 15% tax is, in effect, increased by the 51% tax. *Id.* at 2.

106. *Id.* at 2.

provision was made for taxing only at its source (*e.g.*, in Austria), income from a permanent establishment, from real estate and mortgages thereon, or remuneration from personal services which was taxable where earned; other income was taxable by the country where the recipient resided.¹⁰⁷

Essentially similar basic provisions are reflected in the agreements between Germany and the other eight countries of the European Common Market.¹⁰⁸ These same principles are found in Germany's treaties with the United States and also European countries (except Liechtenstein and Portugal, which have no treaties with Germany).¹⁰⁹

It is interesting to note that in the U.S.-German treaty, Germany exempts from its corporation tax, income derived from a permanent establishment in the United States and dividends derived from a 25%-owned U.S. subsidiary, while the United States grants the credits for foreign taxes as provided in sections 901-05 of the Internal Revenue Code of 1954. Germany incidentally agrees to reduce its 25% *Ertragsteuer* to 15% if the U.S. corporate recipient does not reinvest the dividend in the German company. This treatment was invented by the authorities to prevent German companies from escaping the *Nachsteuer* of 37.08% on undistributed dividends from other corporations, which is levied on a German company which benefits from exemption from corporation tax on dividends from a 25%-owned subsidiary, domestic or foreign, and which does not redistribute the dividend in the same taxable year.

The split rate system was introduced to encourage German companies to distribute their income to stimulate the economy. However, this system is complicated and apparently no longer considered necessary for the original purpose. There is pending, a proposal to replace various taxes on corporations.

Avoidance of Double Taxation of Distributed Income-Proposed Reform

Germany wants to emulate France, with its credit granted resident shareholders from taxes paid by the company equal to 50% of net dividends, and the United Kingdom, with its imputed Advance Corporation Tax qualifying distributions which resident shareholders can credit against their tax liability. It has been proposed¹¹⁰ that, as of January 1, 1976, the

107. AMA INTERNATIONAL TAX CONFERENCE, WEST GERMAN INDUCEMENTS FOR MANUFACTURING AND EXPORTING, Montreal, May 8, 1974.

108. Germany exempts income earned by a German company through a permanent establishment in the other contracting state. Germany also exempts, in general, dividends derived by a German company from a 25%-owned subsidiary in the other contracting state.

109. These principles are also embodied in treaties which Germany has concluded with other countries in Asia, such as India, Indonesia, Iran, Israel, Japan, Pakistan, Sri Lanka, Singapore, Thailand, and Turkey; in Africa, such as Egypt, Liberia, Morocco, South Africa, Tunisia, and Zambia; and in the Western Hemisphere, such as Canada, Jamaica, and Trinidad-Tobago. According to reports, Germany is concluding a new treaty with Argentina and has signed one with Brazil.

110. AMA INTERNATIONAL TAX CONFERENCE, WEST GERMAN INDUCEMENTS FOR MANUFACTUR-

tax on undistributed income will be 56% and that on distributed income 36%, increased by the applicable portion of the corporate income tax which will be applied against the liability of the shareholder. Any excess over his liability will be refunded. Distributions to foreign shareholders will bear a total tax burden of corporate income tax plus a withholding tax of 50%.

This proposal would obviously conflict with the goal of harmonization of corporate taxes in the Common Market and would give rise to the charge of discrimination against residents of other countries which have tax treaties with Germany. This would provoke demands for avoidance of discrimination by the granting of similar credits to residents of other treaty countries, just as France and the United Kingdom have done by amendments to their tax treaties. This new regime is supposed to be enacted by 1976, but persons close to the German situation say that the elections that are expected to take place in Germany in 1976 are likely to provide an excuse for delaying consideration of this problem. Furthermore, the Finance Minister who sponsored it is no longer in office.

Operations Through German Corporations in Third Countries

The fact that Germany grants liberal allowances in its laws and tax treaties, and has negotiated favorable trade arrangements with Iran, Saudi Arabia, and other Arab countries, is prompting tax managers to take a close look at these arrangements to see if it would be worthwhile for a U.S. corporation to organize a German subsidiary corporation to take advantage of them. Generally, the German subsidiary would *not* bear German corporation taxes on profits of branches or dividends from 25%-owned subsidiaries in those countries. It would of course bear, in effect indirectly, the company tax in the third country and any dividend tax withheld at source. If the German company redistributed the income to the U.S. corporation which did not reinvest in the German company, under the German-U.S. treaty, the dividend tax would be limited to 15%.

Incentives to Invest in Developing Countries

The German law contains various incentives to invest in less developed countries (including certain East Bloc countries) by allowing the creation of tax-free reserves of a certain proportion of the investment, depending on whether the investment is in a less developed country and taking into account the lack of development. Once the corporation in the developing country begins to make a profit, it can be distributed as a tax credit to the German parent, free of the German company tax.

Tax Incentives in Germany

Apart from the credits for foreign taxes, the German Federal Govern-

ment has joined with state governments¹¹¹ in a federal-state incentive plan, running from 1973 to 1977. These incentives are provided in three laws:¹¹²

(1) The Investment Premium Act, which envisages investments in depressed areas, including certain border zones and coal mining regions. It provides for cash grants up to 75% of the investment for capital goods needed for manufacturing plants. A subsidy of 7.5% is available for the purchase of new or expanded R & D facilities. In localities with a high priority, combined cash grants and interest subsidies can amount to as much as 22.5% of the investment value.

(2) The Zonal Border Areas Promotion Act, in order to reduce investment in areas bordering East Germany/Czechoslovakia, grants tax incentives and freight subsidies.

(3) The Berlin Promotion Act envisages cash grants (to rise to 25% for purchase or construction of plants and equipment, and 30% for R & D facilities) to any company investing in Berlin. For buildings and equipment located in West Berlin, there are allowed special depreciation rates. The rate of the turnover tax (or tax on added value) on goods manufactured in West Berlin and purchased by West Germans is effectively reduced by more than one third. Incentives are granted to induce workers to come to Berlin, such as reductions in tax rates and increases in wages, bonuses paid per child, interest-free loans to persons newly married, and travel subsidies.

Some states guarantee loans from private lending institutions and contributions toward the cost of interest. Cities offer lower utility rates.

German Law to Prevent Improper Transfer of Profits

Ten years after the United States had enacted, in 1962, subpart F in the Internal Revenue Code¹¹³ to recapture profits that had been transferred to foreign subsidiaries, Germany enacted, in 1973, an "Act to Ensure Equality of Tax Treatment in International Relationships and to Improve the Competitive Situation Regarding the Taxation of Foreign Investments" (called briefly the "Foreign Tax Law").¹¹⁴ The aim is similar to that of

111. Regional Action Programs exist for 21 less developed areas in northern Germany, the eastern border, the south, and the west. Within each incentive region there are designated priority sites which receive the largest share of available incentive funds. It is estimated that these less developed regions embrace 60% of the territory of West Germany and 32% of the population.

112. See AMA INTERNATIONAL TAX CONFERENCE, WEST GERMAN INDUCEMENTS FOR MANUFACTURING AND EXPORTING, Montreal, May 8, 1974.

113. 26 U.S.C.A. §6001 *et seq.* (Rev. 1967).

114. AMA INTERNATIONAL TAX CONFERENCE, WEST GERMAN INDUCEMENTS FOR MANUFACTURING AND EXPORTING, Montreal, May 8, 1974.

subpart F in that this law taxes to a German company, the undistributed income from base company transactions of a controlled foreign affiliate which bears, in another country, a rate less than 30%.

A "controlled foreign corporation" is one in which German residents own directly or indirectly more than 50% of the voting shares. The tax is imposed currently on "base income" which is all income *other than exempted* "active income."¹¹⁵

The "foreign tax law" authorizes the collector to increase a taxpayer's income if it has been artificially reduced by transactions with a related party¹¹⁶ which are not on an arm's length basis. If it is shown that a taxpayer has received unduly low income from a related person, the adjustment can be made. These provisions echo the U.S. regulations on section 482 of the Internal Revenue Code¹¹⁷ in that recourse is first made to the method of the comparable uncontrolled price, and thereafter, to the resale price or cost plus method or another appropriate method under the circumstances. In the case of intangible property, the tax assessor may resort to statistics on royalty rates compiled by German tax auditors and for loans, the tax assessors use the rate of interest prevailing at the residence of the creditor. As a last resort, they may apply the normal return on an investment or the normal gross profit margin.

D. Japan As A Base¹¹⁸

Various Japanese companies such as Nippon Steel, Nissan, and Toshiba might be classed as "transnationals," but they are still oriented primarily in the direction of exports rather than producing and selling outside Japan. Very few U.S.-based TNCs have organized Japanese companies to extend operations into other Asiatic countries.

A Japanese corporation is, in principle, subject to a corporate income tax burden, including local taxes, of something over 48%, but this is reduced by an allowance to obviate the double taxation of dividends and other reliefs which may effectively lower the rate down to 30% or less. The TNC based in Japan with operations in less developed countries, is not only

115. "Active income" includes income from: (1) manufacturing, exploitation, or extraction of resources; (2) sales income, except where goods are purchased from or sold to the controlling domestic taxpayer or an affiliated person, unless it can be established that this selling activity parallels similar sales activity with unrelated third parties; (3) source income, unless derived from services performed by the controlling shareholder or a related person; (4) income from lending, if the funds can be traced to a business outside Germany which aims to derive active income; and (5) dividends from corporations which are owned 25% or more when the dividends are derived from "active business." *Id.*

116. "Related" persons are those having a direct or indirect participation of 25% in the taxpayer, and a third party holding a similar interest in two or more taxpayers. What counts is being in a position effectively to exercise control; not that it is *actually* exercised.

117. 26 U.S.C.A. §482 (Rev. 1967).

118. See C. STEVENS, AMA INTERNATIONAL TAX CONFERENCE, TAX ASPECTS OF JAPAN AS A BASE FOR THE MULTINATIONAL CORPORATION (1974).

entitled to a credit for foreign taxes, but possibly also a credit for experimental and research expenses of roughly up to 25% of the increase of such expenses from a certain base-period. It may be entitled, if classified as a key industry, to a tax-free reserve or the "Overseas Market Development Reserve," which is intended to promote exports by allowing manufacturers to deduct a certain percentage of their receipts from foreign sales. However, this advantage is not available for corporations capitalized at more than a billion yen.¹¹⁹

Corporations are not advised to move into Japan just for tax reasons, but rather to take advantage of the allowances of reserves, such as by organizing a subsidiary in a developing country to qualify for the "Overseas Investment Loss Reserve," or the "National Resources Explorations Investment Loss Reserve."¹²⁰ The "Overseas Investment Loss Reserve" permits deferral of taxes for 5 years on an amount equal to one-half of new investments in developing-country corporations.¹²¹ The objective is really to develop new and stable sources of raw materials for Japanese industry. The "National Resources Exploration Investment Loss Reserve" permits deferral of tax liability for 5 years in an amount of income up to 30%, or even higher to 100%, on new investment in natural resources exploration corporations. This requires approval by Miti. Likewise, special depreciation rates are allowed.

Japan has nearly 30 tax treaties, which allow both the direct and indirect tax credit, subject to the overall limitation.¹²² Attention is called to the income tax convention between the United States and Japan,¹²³ which limits the rate of Japanese tax withheld from dividends paid to a U.S. parent company to 10%, as compared with 15% in general (art. VIA); interest paid to a U.S. corporation not having a permanent establishment in Japan to 10% (art. VI); and royalties, under the same condition, to 10% (art. VI).

V. IMPORTANCE OF U.S.-BASED TNCs

Fortune Magazine published, in August, 1975, timely statistics on the 300 largest industrial corporations outside the United States and the 50 largest industrial companies in the world.¹²⁴

Of the world's 50 largest industrials, 24 are based in the United States,

119. *Id.*

120. *Id.* at 11.

121. *Id.* at 10.

122. *Id.* at 13-14.

123. Double Taxation: Income, March 8, 1971 [1973], 23 U.S.T. 967, T.I.A.S. No. 7365.

124. FORTUNE, August 1975, 155-63. Oil companies account for about half of total sales of the world's 50 largest industrial companies. High oil prices lifted the total sales of these 50 largest corporations by 38% but net income rose by only 12%. For obvious reasons, an increase in sales of 320.1% of the National Iranian Oil Company raised it to number 9 in sales rank—number 3 among those outside the U.S. *Id.* at 155, 163.

which is the dominant country on the list.¹²⁵ American corporations show 57% of total sales, 53% of the assets, 52% of the employees, and 68% of the net income.

These are of course the giants, but an official of the Department of Commerce has estimated that there are probably some 5,000 U.S. corporations with more than 30,000 subsidiaries abroad. These are in addition to those 24 U.S.-based industrials which already have 68% of the net income.

Certainly these statistics are enough to justify an appraisal of the degree to which the U.S. income tax treaties with 22 foreign countries and additional territorial jurisdictions, may have facilitated the inflow of profits of foreign branches, and dividends, interest, and royalties from foreign subsidiaries, as well as income from licenses or services to unrelated companies.

VI. CONCLUSION

Tax considerations have an ever-increasing role in all phases of planning for TNCs. Because of the presence of the same TNC in several countries at the same time, the understanding of how the TNC will be treated is essential to a proper perspective. One should consider the degree to which Developing Countries in the United Nations take into account the political aspects of taxation. It is hoped that this study of what the United States and leading "home countries" have done to mitigate double taxation of their corporations will at least serve as an introduction to a tax man's approach to the study of taxation to U.S.-based transnational corporations.

125. The top 10 are: 1. Exxon, 2. Royal Dutch/Shell Group, 3. General Motors, 4. Ford Motor, 5. Texaco, 6. Mobil Oil, 7. British Petroleum, 8. Standard Oil of California, 9. National Iranian Oil, and 10. Gulf Oil. The next five are headed by British Unilever which is followed by General Electric, IBM, ITT, and Chrysler. *Id.* at 163. Numbers 16 to 20 include Phillips Gloeilampen-fabrieken, U.S. Steel, Standard Oil (Ind.), Cie Francaises des Petroles, and Nippon Steel (Japan). *Id.* Germany leads the next group of five, with August Thyssen-Hutte, BASF, and Hoechst; then Shell Oil and Western Electric. *Id.*

Other American leaders in the top fifty are: Continental Oil (27), E.I. du Pont de Nemours (29), Atlantic Richfield (30), Westinghouse Electric (33), Occidental Petroleum (40), Bethlehem Steel (43), Union Carbide (46), Goodyear Tire & Rubber (47), and Tenneco (49). *Id.*