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INCOME TAX CONVENTION WITH UKRAINE

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Mr. HELMS, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 103–30, 103d Congress, 2d Session, and Treaty Document 104–11, 104th Congress, 1st Session]

The Committee on Foreign Relations, to which was referred the Convention Between the Government of the United States of America and the Government of Ukraine for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, with Protocol, signed at Washington on March 4, 1994, and the exchange of notes dated at Washington May 26 and June 6, 1995 relating to such convention and protocol, having considered the same, reports favorably thereon, without amendment, and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and Ukraine are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country, and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation and facilitate trade and investment between the two countries. It is also intended to enable the two countries to cooperate in preventing avoidance and evasion of taxes.

II. BACKGROUND

The proposed treaty and the proposed protocol were both signed on March 4, 1994. The exchange of notes was dated May 26 and June 6, 1995. Currently, the United States and Ukraine adhere to the provisions of a tax treaty signed June 20, 1973 between the So-

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viet Union and the United States (the "USSR treaty"). The proposed treaty would replace the USSR treaty with respect to Ukraine.

The proposed treaty, together with related protocol, was transmitted to the Senate for advice and consent to its ratification on September 14, 1994 (see Treaty Doc. 103–30). The exchange of notes was transmitted to the Senate for advice and consent to its ratification on June 28, 1995 (see Treaty Doc. 104–11). The Committee on Foreign Relations held a public hearing on the proposed treaty on June 13, 1995.

III. SUMMARY

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty (the "U.S. model"),[1] and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains certain deviations from those models.

As in other U.S. tax treaties, the objectives of the treaty are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard treaty provisions that neither country will tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in such other country unless their contact with the other exceeds specified minimums (Articles 14–17). The proposed treaty provides that dividends and royalties derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 12). Generally, however, dividends, interest, and royalties received by a resident of one country from sources within the other country are to be taxed by the source country on a restricted basis (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for the relief of the potential double taxation by the country of residence allowing a foreign tax credit (Article 24).

The proposed treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 1). In addition, the treaty contains the standard provision that the treaty will not be applied to deny any taxpayer

[1] The U.S. model has been withdrawn from use as a model treaty by the Treasury Department. Accordingly, its provisions may no longer represent the preferred position of U.S. tax treaty negotiations. A new model has not yet been released by the Treasury Department. Pending the release of a new model, comparison of the provisions of the proposed treaty against the provisions of the former U.S. model should be considered in the context of the provisions of comparable recent U.S. treaties.

any benefits he would be entitled to under the domestic law of the country or under any other agreement between the two countries (Article 1); that is, the treaty will only be applied to the benefit of taxpayers.

The proposed treaty differs in certain respects from other U.S. income tax treaties and from the U.S. and OECD model treaties. It also differs in significant respects from the USSR treaty. (That treaty predates the 1981 U.S. model treaty, and was not representative of U.S. treaty policy.) A summary of the provisions of the proposed treaty, including some of these differences, follows:

(1) Like all treaties, the proposed treaty is limited by a "saving clause" (Article 1(3)), under which the treaty is not to affect (subject to specific exceptions) the taxation by either treaty country of its residents or its nationals. Exceptions to the saving clause are similar to those in the U.S. model and other U.S. treaties; the USSR treaty, in contrast, flatly states that it shall not restrict the right of a treaty country to tax its own citizens.

(2) The U.S. excise tax on insurance premiums paid to a foreign insurer is not a covered tax; that is, the proposed treaty would not preclude the imposition of the tax on insurance premiums paid to Ukrainian insurers (Article 2). This is a departure from the USSR treaty and the U.S. model tax treaty, but one that is shared by many U.S. treaties, including recent ones. In addition, the proposed treaty, like the model treaty but unlike the USSR treaty, does not contain a general prohibition on source country taxation of reinsurance premiums derived by a resident of the other country. Nor does the proposed treaty contain the provision of the USSR treaty under which, if the income of a resident of one country is tax-exempt in the other country, the transaction giving rise to that income is exempt from any tax that is or may otherwise be imposed on the transaction.

(3) Like the U.S. model but unlike the USSR treaty, the proposed treaty generally does not cover U.S. taxes other than income taxes, although it does cover taxes on property and excise taxes with respect to private foundations. The proposed treaty does not cover the accumulated earnings tax, the personal holding company tax, and social security taxes.

(4) The proposed treaty makes it clear that each country includes its territorial sea, and also the economic zone and continental shelf in which certain sovereign rights and jurisdiction may be exercised in accordance with international law (Article 3).

(5) By contrast with the USSR treaty, but like the U.S. model, the proposed treaty provides that U.S. citizens are entitled to treaty benefits regardless of actual residence in a third country. In addition, the proposed treaty introduces rules for determining when a person is a resident of either the United States or the Ukraine, and hence entitled to benefits under the treaty (Article 4). The proposed treaty, like the model, provides tie-breaker rules for determining the residence for treaty purposes of "dual residents," or persons having residence status under the internal laws of each of the treaty countries.

(6) Article 5 of the proposed treaty introduces the permanent establishment threshold for one country's imposition of tax on the business profits of a resident of the other country, in conformity

with the U.S. and OECD model treaties. This replaces the concept of a "representation" used in the USSR treaty.

(7) Under the U.S. model treaty, a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, constitutes a permanent establishment only if it lasts more than 12 months. The corresponding rule in the proposed treaty shortens that time period to six months. Under the USSR treaty, the source country is prohibited from taxing the income of a resident of the other country from furnishing engineering, architectural, designing, and other technical services in connection with an installation contract with a resident of the source country and which are carried out in a period not longer than 36 months at one location. The proposed treaty represents a move past the U.S. model treaty, allowing source country taxation under some circumstances that the model would preclude.

(8) The proposed treaty, unlike the model treaties or other U.S. treaties, provides in Article 5(2)(g) that a store or other premises used as a sales outlet constitutes a permanent establishment.

(9) The USSR treaty in general imposes no restriction on the taxation of income from real property by the country in which the property is located. The proposed treaty contains provisions similar to the corresponding model treaty provisions permitting taxation of income from real property by the country in which the real property is located, including the U.S. model treaty provision under which investors in real property in the country not of their residence must be permitted to elect to be taxed on those investments on a net basis. Unlike the U.S. model treaty and most U.S. treaties, but like the OECD model treaty and several recent U.S. treaties, Article 6 of the proposed treaty defines real property to include accessory property, as well as livestock and equipment used in agriculture and forestry.

(10) The business profits article (Article 7) of the proposed treaty overrides the force of attraction rules contained in the Internal Revenue Code ("Code"), providing instead that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. Paragraph 2 of the proposed protocol provides an expansive description of this rule. This is consistent with the U.S. model treaty.

(11) The proposed treaty clarifies that a country may tax profits or income if the other-country resident carries on "or has carried on" business, or has "or had" a fixed base, in that country. Addition of the words "or has carried on" and "or had" clarifies that, for purposes of the treaty rules stated above, any income attributable to a permanent establishment (or fixed base) during its existence is taxable in the country where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) has ceased to exist.

(12) The proposed treaty provides that expenses incurred for the purposes of the permanent establishment are to be allowed as deductions from the taxable income of a permanent establishment. However, the proposed treaty provides that no deductions may be taken in respect of amounts paid by the permanent establishment

to the head office in the form of royalties, fees, or other payments, to the extent that they exceed reimbursements of costs incurred by the head office and allocable to the permanent establishment.

(13) The proposed treaty, similar to the model treaty and similar in some respects to the USSR treaty, provides that income of a resident of one treaty country from the operation of ships or aircraft in international traffic is taxable only in that country (Article 8). Similar to the model treaty, the proposed treaty includes bareboat leasing income in the category of income to which this rule applies. Similar to the model treaty and unlike the present treaty, the proposed treaty provides that income of a treaty-country resident from the use or rental of containers and related equipment used in international traffic shall be taxable only in that country.

(14) Article 9 of the proposed treaty corresponds to the associated enterprises article in the U.S. model treaty. In particular, the proposed treaty contains a "correlative adjustment" clause, providing that either treaty country must correlatively adjust any tax liability it previously imposed on a person for income reallocated to a related person by the other treaty country. The USSR treaty contains no associated enterprises article.

(15) The USSR treaty generally imposes no restriction on the source-country taxation of dividends. The proposed treaty, similar to the U.S. model treaty, provides in Article 10 that direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) generally will be taxable by the source country at a rate no greater than 5 percent. Other dividends generally are taxable by the source country at a rate no greater than 15 percent.

(16) Like recent U.S. treaties, the proposed protocol provides that dividends paid by a U.S. regulated investment company would be subject to source country taxation at the 15-percent limit (paragraph 3). On the other hand, like some recent U.S. treaties, the proposed treaty and proposed protocol impose no restriction on the source country taxation of dividends paid by a U.S. real estate investment trust.

(17) The USSR treaty generally imposes no restriction on the U.S. branch profits tax. The proposed treaty, similar to U.S. treaties negotiated since 1986, expressly permits the United States to impose the branch profits tax, but at a rate not exceeding 5 percent (Article 10(5)).

(18) The USSR treaty limits the source-country taxation of interest only in the case of interest in connection with the financing of trade between the United States and the Soviet Union. The proposed treaty, like the U.S. model and numerous U.S. treaties, generally prohibits source country taxation on interest (Article 11). However, the proposed treaty provides that income from any arrangement, including a debt obligation, carrying the right to participate in profits and treated as a dividend by the source country according to its internal laws, may be taxed by the source country as a dividend. Thus, for example, the country of source could withhold tax on deductible interest paid under an "equity kicker" loan, at rates applicable to dividends. There is no similar provision in the U.S. or OECD model treaties.

(19) The proposed protocol (paragraph 4) provides that the interest article in the proposed treaty does not interfere with the jurisdiction of the United States to tax under its internal law an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (a "REMIC"). Currently, internal U.S. law applies regardless of treaties that were in force when the REMIC provisions were enacted.

(20) Unlike the model treaties and the USSR treaty, the proposed treaty provides that royalties may be taxed by both treaty countries, rather than by the residence country only. Taxation of royalties by the source country is limited by the proposed treaty to a rate of 10 percent (Article 12). Royalties are defined as payments for the use of certain rights, property, or information. Unlike the model treaty, the proposed treaty does not treat as royalties gains from the alienation of rights or property which are contingent on the productivity, use, or further alienation of such rights or property. The taxation of such gains is governed by the proposed treaty's gains article, which, in a manner similar to the royalties article of the model treaties, generally reserves taxing jurisdiction to the residence country (Article 13).

(21) Both the U.S. model treaty and the proposed treaty provide for source-country taxation of capital gains from the disposition of personal property used in the business of a permanent establishment in the source country. Unlike most recent U.S. tax treaties, however, the proposed treaty does not specifically provide for source-country taxation of such gains where the payments are received after the permanent establishment has ceased to exist.

(22) Both the U.S. model treaty and the proposed treaty provide for source-country taxation of capital gains from the disposition of real property regardless of whether the taxpayer is engaged in a trade or business in the source country. The proposed treaty expands the U.S. model treaty definition of real property for these purposes to encompass U.S. real property interests. This safeguards U.S. tax under the Foreign Investment in Real Property Tax Act of 1980, which applies to dispositions of U.S. real property interests by nonresident aliens and foreign corporations.

(23) The proposed treaty exempts all other gains from source-country taxation (Article 13(4)). This generally includes gains from the alienation of ships, aircraft, or containers operated in international traffic.

(24) In a manner similar to the U.S. model treaty, Article 14 of the proposed treaty provides that income derived by a resident of one of the treaty countries from the performance of professional or other personal services in an independent capacity generally would not be taxable in the other treaty country unless the services are or were performed in that other country and the person has or had a fixed base there regularly available for the performance of his or her activities. In such a case, the other country would be permitted to tax the income from services performed in that country attributable to the fixed base.

(25) The dependent personal services article of the proposed treaty (Article 15) is similar to that article of the U.S. model. Under the proposed treaty, salaries, wages, and other similar remuneration derived by a resident of one treaty country in respect of em-

ployment exercised in the other country is taxable only in the residence country (i.e., is not taxable in the other country) if the recipient is present in the other country for a period or periods not exceeding in the aggregate 183 days in the taxable year concerned and certain other conditions are satisfied.

(26) Article 16 of the proposed treaty allows directors' fees and similar payments derived by a resident of one treaty country for services performed outside the residence country in his or her capacity as a member of the board of directors (or another similar body) of a company that is a resident of the other country to be taxed in that other country. The U.S. model treaty, on the other hand, generally treats directors' fees under other applicable articles, such as those on personal service income. Under the U.S. model treaty (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal services income and the source country tax on directors' fees is limited. By contrast, under the OECD model treaty, the country where the company is resident has full taxing jurisdiction over directors' fees and other similar payments the company makes to residents of the other treaty country, regardless of where the services are performed. Thus, the proposed treaty represents a compromise between the U.S. model treaty and the OECD model treaty positions.

(27) Similar to the U.S. model treaty, Article 17 of the proposed treaty allows a source country to tax income derived by artistes and sportsmen from their activities as such, without regard to the existence of a fixed base or other contacts with the source country. The U.S. model treaty, however, allows such taxation by the source country only if that income exceeds $20,000 in a taxable year. U.S. income tax treaties generally follow the U.S. model treaty's rule, but often use a lower annual income threshold. Unlike the U.S. model treaty, but like the OECD model treaty, the proposed treaty allows entertainers and sportsmen to be taxed by the country of source, regardless of the amount of income that they earn from artistic or sporting endeavors.

The proposed treaty includes an exception from source country taxation of artistes and sportsmen resident in the other country if the visit to the source country is substantially supported by public funds from the country of residence. Neither the U.S. model nor the OECD model contains such an exception, although it is found in some recent U.S. tax treaties.

(28) The proposed treaty modifies the USSR treaty's rule, similar to the U.S. model treaty's rule, that compensation paid by a treaty country government to one of its citizens for services rendered to that government in the discharge of governmental functions may only be taxed by that government's country. Under Article 18 of the proposed treaty, as under the OECD model treaty and other U.S. treaties, such compensation generally may only be taxed by the recipient's country of residence, if the services are rendered in that country and the recipient is a citizen of that country or (in the case of remuneration other than a pension) did not become a resident of that country solely for the purpose of rendering the services.

(29) The proposed treaty, like the U.S. model treaty and unlike the USSR treaty, expressly provides for the taxation of pensions in

general only by the residence country, and for the taxation of social security benefits and other public pensions not arising from government service only in the source country (Article 19).

(30) Unlike the U.S. model treaty, the proposed treaty makes no special provision for the treatment of annuities, alimony, or child support payments. Taking into account the other income article which generally provides for taxation by the country of residence, the result in the case of annuities and alimony is generally similar to that under the U.S. model treaty; the result in the case of child support may not be.

(31) The USSR treaty, unlike the model treaties, precludes each country from taxing a resident of the other country who is temporarily present in the first country as a journalist, media correspondent, teacher, or researcher; or who is temporarily present to participate in an exchange program for intergovernmental cooperation in science and technology, or to study or gain technical, professional, or commercial experience. These exemptions generally extend only to income or allowances connected with the purpose of the visit, and only for such period as is required to effectuate the purpose of the visit, but not more than 2 years in the case of teachers and researchers, 5 years in the case of students, and one year in other cases.

The proposed treaty contains a narrower set of limitations on host-country taxation of temporary visitors (Article 20) than does the USSR treaty. The limitations do not apply to visits for teaching or for journalism. They also do not provide an exemption for employment income. The proposed treaty prohibits the host country from taxing certain payments from abroad for the purpose of the individual's maintenance, education, study, research, or training. Temporary presence in the host country must be for the purpose of studying at an educational institution; training as required to practice a profession; or studying or doing research as a recipient of a grant from a governmental, religious, charitable, scientific, literary, or educational organization. In the last case, the proposed treaty prohibits the host country from taxing the grant. The exemptions apply no longer than the period of time ordinarily necessary to complete the study, training or research. Moreover, no exemption for training or research will extend for a period exceeding five years. The exemption from host country tax does not apply to income from research if the research is undertaken for private benefit.

(32) The proposed treaty, unlike the USSR treaty, contains a version of the standard other income article, found in the model treaties and more recent U.S. treaties, under which income not dealt with in another treaty article generally may be taxed only by the residence country (Article 21).

(33) The proposed treaty contains a limitation on benefits, or "anti-treaty shopping," article similar to the limitation on benefits articles contained in recent U.S. treaties and protocols and in the branch tax provisions of the Code (Article 22). The limitation on benefits article in the proposed treaty is virtually identical to the corresponding provisions of the recent U.S. income tax treaty with the Russian Federation.

(34) Unlike most U.S. treaties and the model treaties, the USSR treaty has no provision providing relief from double taxation. In the general case this absence may have little or no impact on a U.S. person, as the United States provides relief from double taxation by internal law, through the foreign tax credit. The proposed treaty provides that each country shall allow its residents (and the United States its citizens) a credit for income taxes imposed by the other country (Article 24). However, such credits need only be in accordance with the provisions and subject to the limitations of internal law (as it may be amended from time to time without changing the general principle that credits must be allowed). In addition, unlike the U.S. model and other U.S. treaties, the proposed treaty does not include a specific provision for the operation of foreign tax credits in the case of a U.S. citizen resident in Ukraine.

(35) U.S. law allows taxpayers credit for foreign taxes only if the foreign taxes are directed at the taxpayer's net gain. Thus the sufficiency of deductions allowed under foreign law is relevant to the creditability of foreign tax against U.S. tax liability. At times, Soviet and Ukrainian law have in effect placed significant restrictions on labor and interest cost deductions. In order to assist U.S. taxpayers' ability to take U.S. credits for Ukrainian taxes, Ukraine confirms under the proposed protocol (paragraph 7) that its law permits certain Ukrainian entities deductions for interest (whether paid to a bank or another person and without regard to the term of the loan) and for actual wages and other remuneration for personal services, regardless of its internal law, if U.S. residents beneficially own at least 20 percent of the entity, and the entity has total corporate capital of at least $100,000. This confirmation also applies to Ukrainian permanent establishments of U.S. entities, and individual U.S. citizens and residents pursuing entrepreneurial activities in Ukraine. On the basis of these required deductions, the proposed protocol treats Ukraine's taxes as income taxes that are eligible for the U.S. foreign tax credit.

(36) The proposed treaty does not provide for "tax sparing" or other fictitious credits for taxes forgiven by one treaty country to residents of the other country under an incentive program. Like some other U.S. treaties, however, paragraph 7(d) of the proposed protocol indicates that the United States and Ukraine will amend the proposed treaty to provide such credits in the event that the United States either amends its internal laws to allow such credits or agrees to provide them in a tax treaty with any other country.

(37) Article 25 of the proposed treaty greatly expands the nondiscrimination rule in the USSR treaty, in some respects conforming it to the U.S. model, and in other respects providing additional benefits. The USSR treaty requires "national treatment" to the extent of prohibiting discrimination under the laws of one country against citizens of the other country resident in the first country. It requires "most-favored-nation treatment" to the extent of prohibiting less favorable treatment, under the laws of one country, of citizens of the other country resident in the first country, or of local representations of residents of the other country, than the treatment afforded to third-country citizens and representations of third-country residents. The proposed treaty also requires both "national treatment" to the extent required in the U.S. model and a

form of "most-favored-nation treatment" (not taking into account special agreements, such as bilateral income tax treaties, with third countries) to be applied to citizens and residents of the treaty countries. The proposed treaty affords these benefits to citizens of the other country in the same circumstances as citizens of the first country, regardless of residence; to the local permanent establishments of residents of the other country, and to enterprises owned by residents of the other country. In addition, the proposed treaty prohibits discrimination against the deductibility of amounts paid to residents of the other country. Like the U.S. model treaty, the nondiscrimination rules of the proposed treaty apply not only to all national-level taxes, but also to all taxes imposed by each country's political subdivisions and local authorities.

(38) Like the U.S. model treaty, and unlike the USSR treaty, the proposed treaty makes express provision for the competent authorities mutually to agree on topics that would arise under the proposed treaty, but are not mentioned in the present treaty's mutual agreement article, such as the characterization of particular items of income, the common meaning of a term, and the elimination of double taxation in cases not provided for in the treaty (Article 26).

(39) Unlike some of the other pending treaties, the proposed treaty does not provide that its dispute resolution procedures under the mutual agreement article would take precedence over the corresponding provisions of any other agreement between the United States and Ukraine in determining whether a law or other rule is within the scope of the proposed treaty. Therefore, under the treaty as proposed, if Ukraine accedes to the General Agreement on Trade in Services (the "GATS"), tax issues between the United States and Ukraine may be subject to the dispute resolution procedures of the World Trade Organization. This issue is addressed in the exchange of notes dated May 26 and June 6, 1995, which constitutes an agreement that will enter into force on the date the treaty enters into force. The exchange of notes provides that, in the event the GATS applies between the United States and Ukraine, the dispute resolution procedures under the mutual agreement article of the proposed treaty would take precedence.

(40) While the USSR treaty requires exchanges of information only to the extent of providing information about changes in internal law, the proposed treaty includes the standard exchange of information article, similar to that in the U.S. model, which contemplates that each competent authority will assist the other in obtaining and transmitting information that relates to the assessment, collection, enforcement, and prosecution of tax claims against particular taxpayers (Article 27). The proposed treaty omits the U.S. model provision pledging assistance in collecting such amounts as may be necessary to ensure that treaty relief does not enure to the benefit of persons not entitled thereto.

(41) Paragraph 5 of the proposed protocol expressly provides that where the treaty limits the right to collect taxes, which taxes are nevertheless withheld at source at the rates provided for under in-

ternal law, refunds will be made in a timely manner on application by the taxpayer.[2]

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country, and instruments of ratification are to be exchanged as soon as possible at Kiev. In general, the proposed treaty will enter into force when the instruments of ratification are exchanged. The exchange of notes constitutes an agreement which will enter into force when the treaty enters into force. The USSR treaty generally ceases to have effect once the provisions of the proposed treaty take effect.

With respect to taxes withheld at source on dividends, interest or royalties, the proposed treaty will be effective for amounts paid or credited on or after the first day of the second month following entry into force. With respect to other taxes, the proposed treaty is to be effective for taxable periods beginning on or after the first of January following entry into force.

Where greater benefits would have been available to a taxpayer under the USSR treaty than under the proposed treaty, the taxpayer may elect to be taxed under the USSR treaty (in its entirety) for the first taxable year with respect to which the proposed treaty would otherwise have effect. Moreover, in the case of a taxpayer claiming the benefits of Article III(1)(d) of the USSR Treaty (providing for taxation only by the source country of income from the furnishing of engineering, architectural, designing or other technical services in connection with an installation contract which are carried out in a period not exceeding 36 months at one location), the taxpayer may elect to be taxed under the USSR treaty (in its entirety) for the duration of the period of benefits provided by that subparagraph.

B. TERMINATION

The proposed treaty will continue in force until terminated by either country. Either country may terminate the treaty at any time after five years from the date of its entry into force by giving at least six months prior written notice through diplomatic channels. A termination will be effective with respect to taxes withheld at source for amounts paid or credited on or after the first of January following the expiration of the six month period. A termination will be effective with respect to other taxes for taxable periods beginning on or after the first of January following the expiration of the six month period.

V. Committee Action

The Committee on Foreign Relations held a public hearing on the proposed treaty with Ukraine, the related protocol, and the ex-

[2] The provision of the proposed protocol refers specifically to Article 14 (independent personal services) of the proposed treaty. The Committee understands that the reference to Article 14 was intended solely to emphasize that the refund provision applies to withholding taxes on payments for personal services as well as withholding taxes on, for example, dividends, interest, and royalties.

change of notes, as well as on other proposed tax treaties and protocols, on June 13, 1995. The hearing was chaired by Senator Thompson. The Committee considered the proposed treaty with Ukraine on July 11, 1995, and ordered the proposed treaty, the protocol, and the exchange of notes favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty, the protocol, and the exchange of notes.

VI. Committee Comments

On balance, the Committee on Foreign Relations believes that the proposed treaty with Ukraine is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. The Committee has taken note of certain issues raised by the proposed treaty, and believes that the following comments may be useful to U.S. Treasury officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. Relationship to Uruguay Round Trade Agreements

The multilateral trade agreements encompassed in the Uruguay Round Final Act, which entered into force as of January 1, 1995, include the GATS. This agreement generally obligates members and their political subdivisions to afford persons resident in member countries (and related persons) "national treatment" and "most-favored-nation treatment" in certain cases relating to services. The GATS applies to "measures" affecting trade in services. A "measure" includes any law, regulation, rule, procedure, decisions, administrative action, or any other form. Therefore, the obligations of the GATS extend to any type of measure, including taxation measures.

However, the application of the GATS to tax measures is limited by certain exceptions under Article XIV and Article XXII(3). Article XIV requires that a tax measure not be applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services. Article XIV(d) allows exceptions to the national treatment otherwise required by the GATS, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other members. "Direct taxes" under the GATS comprise all taxes on income or capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises as well as taxes on capital appreciation.

Article XXII(3) provides that a member may not invoke the GATS national treatment provisions with respect to a measure of another member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In case of disagreement between members as to whether a measure falls within the scope of such an agreement between them, either member may bring this matter before the Council for Trade in Services. The Council is to refer the matter to arbitration; the decision of the arbitrator is final and binding on the members. However, with respect to agreements on the avoidance of double taxation that are in force on January 1, 1995, such a matter may be brought before the Council for Trade in Services only with the consent of both parties to the tax agreement.

Article XIV(e) allows exceptions to the most-favored-nation treatment otherwise required by the GATS, provided that the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement by which the member is bound.

The United States is a party to the GATS, but the Ukraine is not yet a party thereto. However, the exchange of notes addresses the relationship between the proposed treaty and the GATS, in the event that the GATS applies between the United States and Ukraine, and the relationship between the proposed treaty and other agreements that apply between the two countries. The exchange of notes provides that, in the event the GATS applies between the United States and Ukraine, a dispute concerning whether a measure is within the scope of the proposed treaty is to be considered only by the competent authorities under the dispute settlement procedures of the proposed treaty. Moreover, the exchange of notes provides that the nondiscrimination provisions of the proposed treaty are the only nondiscrimination provisions that may be applied to a taxation measure unless the competent authorities determine that the taxation measure is not within the scope of the proposed treaty (with the exception of nondiscrimination obligations under the General Agreement on Tariffs and Trade ("GATT") with respect to trade in goods, provided that GATT applies between the United States and Ukraine).

The Committee believes that it is important that the competent authorities are granted the sole authority to resolve any potential dispute concerning whether a measure is within the scope of the proposed treaty and that the nondiscrimination provisions of the proposed treaty are the only appropriate nondiscrimination provisions that may be applied to a tax measure unless the competent authorities determine that the proposed treaty does not apply to it (except nondiscrimination obligations under GATT with respect to trade in goods, if it applies between the United States and Ukraine). The Committee also believes that the provision of the exchange of notes is adequate to preclude the preemption of the mutual agreement provisions of the proposed treaty by the dispute settlement procedures under the GATS (in the event that it applies between the United States and Ukraine).

B. FOREIGN TAX CREDIT FOR UKRAINIAN TAXES

Tax policy

To be creditable under the limitations of U.S. law, a foreign tax must be directed at the taxpayer's net gain. Like any foreign taxes, the Ukrainian tax on income (profits) of enterprises and the income tax on individuals have been imposed on a base that is not necessarily identical to the U.S. income tax base. For example, the Committee understands that at the time the proposed treaty was signed, Ukrainian tax laws did not allow full deductions for labor costs. In order to assist U.S. taxpayers seeking eligibility of Ukrainian taxes for use as credits against U.S. tax, as discussed above in Part III, the proposed protocol requires Ukraine to provide interest and labor cost deductions in the case of certain U.S. persons and entities with U.S. ownership. In addition, on the basis of those required deductions, the proposed protocol provides that the Ukrainian taxes will be creditable for U.S. purposes.[3]

It generally has not been consistent with U.S. tax policy for deductions from the U.S. tax base of a U.S. person to be granted by treaty. Nor has it been consistent with U.S. tax policy to guarantee by treaty the U.S. creditability of an otherwise non-creditable foreign tax. It is believed that both functions are generally more appropriately served in the normal course of internal U.S. tax legislation. The proposed treaty attempts to be consistent with these principles, while accommodating the differences between Ukraine's and the United States's internal constitutional processes. As a result, the treaty commits Ukraine to altering its internal tax base with respect to foreign-owned investments, in order to conform Ukraine's taxes to the requirements of the U.S. foreign tax credit. However, the proposed treaty takes the unusual additional step of guaranteeing that the Ukrainian tax, with the assurances described in the proposed protocol, is eligible for the U.S. foreign tax credit.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department to provide additional explanation regarding the precedential effect of the guarantee of creditability. The relevant portion of the Treasury Department's July 5, 1995 letter[4] responding to this inquiry is reproduced below:

> 2. How will the guarantee of U.S. creditability in the proposed treaty not set a precedent in this area? Doesn't this section erode general tax treaty principles?
>
> As of the date of signature of the treaty, the Ukrainian income tax would have been a creditable tax under U.S. regulations had wages and interest been fully deductible. Therefore, given the guarantee of interest and wage deductions in the treaty, the treaty provisions stating that the Ukrainian tax is creditable for U.S. tax purposes did not make an otherwise non-creditable tax creditable—given this modification of Ukrainian law, the tax was fully creditable with or without the treaty guarantee. This provision therefore does not represent a meaningful concession by the United States. It does however, provide additional assurance to U.S. investors that they will not face double taxation as a result of being denied foreign tax credits for Ukrainian income taxes paid, and in that sense is a useful provision.

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[3] The Committee understands that the proposed protocol would not treat as creditable the Ukrainian taxes imposed on a taxpayer that is not eligible for the full deductions, as provided in the proposed protocol.

[4] Letter from Assistant Secretary of the Treasury (Tax Policy) Leslie B. Samuels to Senator Fred Thompson, Committee on Foreign Relations, July 5, 1995 ("July 5, 1995 Treasury Department letter").

Stability of Ukrainian tax law

The Committee understands that Ukraine enacted one phase of its tax reform in April 1995. The Treasury Department has advised the Committee that the Ukrainian tax reform is changing the tax base generally from gross receipts to net income. In particular, it is understood that businesses are allowed deductions for wages, salaries and related expenses, interest and bank charges, and costs of production and depreciation charges.

The 1992 U.S. income tax treaty with the Russian Federation included a similar provision to the proposed protocol's special deduction rules for the labor and interest expenses of certain foreign-owned entities. However, despite allowing deductions for all wages paid under the treaty, the Russian Federation subsequently enacted an excess-wage tax that applies to wages that exceed six times the minimum monthly wage. The package of amendments to the Russian tax laws that took effect recently continue the excess-wage tax at least through 1995.[5] Under the terms of the U.S.-Russia tax treaty, the United States is not permitted to terminate the treaty until 1999.[6]

Most tax treaty partners of the United States have long-established tax systems. The states of the former Soviet Union generally have not yet had the opportunity fully to develop their economies and tax systems. It is less common for the United States to use a tax treaty as a device to stabilize the economy or tax system of a country undergoing development or transition. The Russian excess-wage tax is an example of how a tax treaty alone may not be completely effective toward this goal. Nonetheless, in such circumstances as those found in the Russian Federation, the tax treaty may afford U.S. investors and the U.S. Government a useful forum in which to air certain grievances that may arise in the area of fiscal policy.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department to provide additional explanation regarding the role of a country's political situation in the decision to ratify a treaty with the country. The relevant portion of the July 5, 1995 Treasury Department letter responding to this inquiry is reproduced below:

> 9. What role should a country's political situation play, particularly in developing countries, in determining whether to ratify these treaties?
>
> A country's political situation is a factor that is considered in determining whether to build stronger economic ties with that country. When consideration of this and other factors leads to a policy of building stronger economic ties with a particular country, a tax treaty becomes a logical part of that policy. One of a treaty's main purposes is to foster the competitiveness of U.S. firms that enter the treaty partner's market place. As long as it is U.S. policy to encourage U.S. firms to compete in these

[5] Bureau of National Affairs, Daily Tax Report, May 1, 1995, p. G–2. The Committee understands that the Russian Federation may intend to terminate the excess-wage tax as of 1996.

[6] The United States has rarely terminated a tax treaty in response to changes in the tax laws of a treaty partner. Despite the changes, it is usually desirable to continue the tax treaty relationship for the sake of other treaty benefits until the treaty can be renegotiated.

> market places, it is in the interest of the United States to enter tax treaties.
>
> Moreover, in countries where an unstable political climate may result in rapid and unforeseen changes in economic and fiscal policy, a tax treaty can be especially valuable to U.S. companies, as the tax treaty may restrain the government from taking actions that would adversely impact U.S. firms, and provide a forum to air grievances that otherwise would be unavailable.

The Committee believes that the political and economic situation in countries with which the U.S. is entering into bilateral agreements is an important aspect in the Senate's decision to advise and consent to ratification. The Committee supports the progress that Ukraine is making in democratic reforms. The current President, Leonid Kuchma, was freely elected and took office in a peaceful transfer of power. While the Ukrainian parliament (the Rada) is dominated by former Communists, it has been generally supportive of economic and democratic reforms and recently forfeited some of its Soviet-era powers. The pace of economic reform in Ukraine has picked up with the election of President Kuchma. The Ukrainian government is operating under a tight budget and significant economic reform measures are being implemented.

Ukraine holds great potential for U.S. investors and ratification of the proposed treaty would provide a more predictable investment climate. Due to accelerating reforms it is likely that, in the short term, related economic duress and discontent will increase. Ratification of the proposed treaty now would lock in a framework for U.S.-Ukraine economic relations that may be politically untenable later. The United States has a strong interest in the success of Ukraine's economic and democratic reform process. Recent Ukrainian actions support favorable consideration of the proposed treaty. Ultimately, a strong and independent Ukraine is important to the stability of Europe and to overall U.S. foreign policy interests.

C. DEVELOPING COUNTRY CONCESSIONS

The proposed treaty contains a number of developing country concessions, some of which are found in other U.S. income tax treaties with developing countries. The most significant of these concessions are listed below.

Definition of permanent establishment

The proposed treaty departs from the U.S. and OECD model treaties by providing for broader source-basis taxation. The proposed treaty's permanent establishment article, for example, would permit the country in which business activities are carried on to tax the activities sooner, in certain cases, than it would be able to under either of the model treaties. Under the proposed treaty, a building site or construction or installation project (or supervisory activities related to such projects) would create a permanent establishment if it exists in a country for more than six months; under the U.S. model, a building site, etc., must last for at least one year. Thus, for example, under the proposed treaty, a U.S. enterprise's business profits that are attributable to a construction project in

Ukraine would be taxable by Ukraine if the project lasts for more than six months. Similarly, under the proposed treaty, the use of a drilling rig or ship for the exploration or exploitation of natural resources (or related supervisory activities) in a country for more than six months would create a permanent establishment there; under the U.S. model, drilling rigs or ships must be present in a country for at least one year. It should be noted that many tax treaties between the United States and developing countries provide a permanent establishment threshold of six months for building sites and drilling rigs. In addition, unlike under the model treaties or other U.S. tax treaties, a permanent establishment under the proposed treaty includes a store or other premises used as a sales outlet.

Source basis taxation

Additional concessions to source basis taxation in the proposed treaty include a maximum rate of source country tax on royalties (10 percent) that is higher than that provided in the U.S. model treaty; and broader source country taxation of personal services income (especially directors' fees) and income of artistes and athletes than that allowed by the U.S. model treaty.

Taxation of business profits

Unlike the U.S. model treaty, but similar to the United Nations model treaty, the proposed treaty would limit certain deductions for expenses incurred on behalf of a permanent establishment by the enterprise's head office. Unlike some other U.S. tax treaties with developing countries (such as Mexico and India), the proposed treaty's prohibition on deductions for amounts paid by the permanent establishment to its home office does not apply differently to interest payments than to royalties or other fees.

Committee conclusions

One purpose of the proposed treaty is to reduce tax barriers to direct investment by U.S. firms in Ukraine. The practical effect of these developing country concessions could be greater Ukrainian taxation of future activities of U.S. firms in Ukraine than would be the case under the rules of either the U.S. or OECD model treaties.

There is a risk that the inclusion of these developing country concessions in the proposed treaty could result in additional pressure on the United States to include them in future treaties negotiated with developing countries, especially other nations of the former Soviet Union. However, these precedents already exist in the UN model treaty, and a number of existing U.S. income tax treaties with developing countries already include similar concessions. Such concessions arguably are necessary in order to obtain treaties with developing countries. Tax treaties with developing countries can be in the interest of the United States because they provide developing country tax relief for U.S. investors and a clearer framework within which the taxation of U.S. investors will take place.

The Committee is concerned that developing country concessions not be viewed as the starting point for future negotiations with developing countries. It must be clearly recognized that several of the rules of the proposed treaty represent substantial concessions by the United States, and that such concessions must be met with substantial concessions by the treaty partner. Thus, future negotiations with developing countries should not assume, for example, that the definition of permanent establishment provided in this treaty will necessarily be available in every case; rather, such a definition will be only adopted in the context of an agreement that satisfactorily addresses the concerns of the United States.

D. TREATY SHOPPING

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty is intended to benefit residents of Ukraine and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as "treaty shopping." Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of tax by lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing in that treaty country a subsidiary, trust, or other investing entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty-shopping provision of the proposed treaty is similar to an anti-treaty shopping provision in the Code (as interpreted by Treasury regulations) and in several newer treaties. Some aspects of the provision, however, differ either from an anti-treaty-shopping provision proposed at the time that the U.S. model treaty was proposed, or from the anti-treaty-shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty-shopping provision of the treaty effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty-shopping article of the proposed treaty is more lenient than the comparable rule in one version proposed with the U.S. model. That U.S. model proposal allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several newer treaties and an anti-treaty-shopping provision in the Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor is considerably easier to enter under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty-shopping article differs from the comparable rule in some earlier U.S. treaties and proposed model provisions, but the effect of the change is less clear. The general test applied by those treaties to allow benefits, short of meeting the bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty gives the competent authority of the source country the ability to override this standard. The Technical Explanation accompanying the treaty provides some elaboration as to how these rules will be applied.

The practical difference between the proposed treaty tests and the earlier tests will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty tests (i.e., would operate to deny benefits in potentially abusive situations more often).

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department to provide additional explanation regarding the sufficiency of the anti-treaty shopping provisions in the proposed treaty and other treaties. The relevant portion of the July 5, 1995 Treasury Department letter responding to this inquiry is reproduced below:

> 7. Is Treasury confident that the anti-treaty shopping provisions in these treaties will ensure full payment of taxes by multinational corporations and eliminate abuse of the treaties to lower taxes?
>
> In conjunction with various domestic statutes and regulations, the limitation on benefits provisions should be very effective in preventing underpayment of U.S. withholding taxes by non-residents, including multinationals.

The Committee continues to believe that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The Committee continues to believe further that, in exercising any latitude Treasury has to adjust the operation of the proposed treaty, the rules as applied should adequately deter treaty shopping abuses. The USSR treaty does not contain anti-treaty shopping rules. Further, the proposed anti-treaty shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Ukraine since third-country investors may be unwilling to share ownership of such investing entities on a 50-50 basis with

U.S. or Ukrainian residents or other qualified owners to meet the ownership test of the anti-treaty shopping provision. In addition, the base erosion test provides protection from certain potential abuses of a Ukrainian conduit. Finally, Ukraine imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Ukrainian entities to make U.S. investments. On the other hand, implementation of the tests for treaty shopping set forth in the treaty may raise factual, administrative, or other issues that cannot currently be foreseen. The Committee emphasizes that the proposed provision must be implemented so as to serve as an adequate tool for preventing possible treaty-shopping abuses in the future.

E. TRANSFER PRICING

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to reallocate profits among related enterprises residing in each country, if a reallocation is necessary to reflect the conditions which would have been made between independent enterprises. The Code, under section 482, provides the Secretary of the Treasury the power to make reallocations wherever necessary in order to prevent evasion of taxes or clearly to reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies is fully consistent with the proposed treaty.[7] A significant function of this authority is to ensure that the United States asserts taxing jurisdiction over its fair share of the worldwide income of a multinational enterprise. The arm's-length standard has been adopted uniformly by the leading industrialized countries of the world, in order to secure the appropriate tax base in each country and avoid double taxation, "thereby minimizing conflict between tax administrations and promoting international trade and investment."[8]

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S. share of multinational income.[9] Some prefer a so-called "formulary apportionment" approach, which can take a variety of forms. The general thrust of formulary apportionment is first to measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing rights over portions of the whole. Some prefer an approach that is

[7] The OECD report on transfer pricing generally approves the methods that are incorporated in the current Treasury regulations under section 482 as consistent with the arm's-length principles upon which Article 9 of the proposed treaty is based. See "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," OECD, Paris 1995.

[8] Id. (preface).

[9] See generally "The Breakdown of IRS Tax Enforcement Regarding Multinational Corporations: Revenue Losses, Excessive Litigation, and Unfair Burdens for U.S. Producers: Hearing before the Senate Committee on Governmental Affairs," 103d Cong., 1st Sess. (1993) (hereinafter, "Hearing Before the Senate Committee on Governmental Affairs").

based on the expectation that an investor generally will insist on a minimum return on investment or sales.[10]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the nondiscrimination rules embodied in Article 25.[11] Some, who advocate a change in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change. The Committee is concerned about whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

As part of its consideration of the proposed treaty, the Committee requested the Treasury Department to provide additional explanation regarding the Administration's current policy with respect to transfer pricing issues, the use of the arm's length pricing method, and the application of treaties to ensure full payment of required taxes by foreign corporations. The relevant portions of the July 5, 1995 Treasury Department letter responding to these inquiries are reproduced below:

> 1. Please describe the position of the U.S. Treasury with regard to the transfer pricing issue.
>
> While estimates of the magnitude of the problem vary, Treasury regards transfer pricing as one of the most important international tax issues that it faces. Treasury believes that both foreign and U.S.-owned multinationals have engaged in significant income shifting through improper transfer pricing.
>
> Treasury identified three problems that allowed these abuses to occur: (1) lack of substantive guid-

[10] "See Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means," 101st Cong., 2d Sess. 360–61 (1990) (statement of James E. Wheeler); H.R. 460, 461, and 500, 103d Cong., 1st Sess. (1993); sec. 304 of H.R. 5270, 102d Cong., 2d Sess. (1992) (introduced bills); see also "Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means," 102d Cong., 2d Sess. (1992).

[11] Compare "Tax Conventions with: The Russian Federation, Treaty Doc. 102–39;" "United Mexican States, Treaty Doc. 103–7;" "The Czech Republic, Treaty Doc. 103–17;" "The Slovak Republic, Treaty Doc. 103–18"; and "The Netherlands, Treaty Doc. 103–6." "Protocols Amending Tax Conventions with: Israel, Treaty Doc. 103–16;" "The Netherlands, Treaty Doc. 103–19;" and "Barbados, Treaty Doc. 102–41." "Hearing Before the Committee on Foreign Relations, United States Senate," 103d Cong., 1st Sess. 38 (1993) ("A proposal to use a formulary method would be inconsistent with our existing treaties and our new treaties.") (oral testimony of Leslie B. Samuels, Assistant Secretary for Tax Policy, U.S. Treasury Department); a statement conveyed by foreign governments to the U.S. State Department that "[worldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher, U.S. Secretary of State); and "American Law Institute Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties" (1992), at 204 (n. 545) ("Use of a world-wide combination unitary apportionment method to determine the income of a corporation is inconsistent with the "Associated Enterprises" article of U.S. tax treaties and the OECD model treaty") with "Hearing Before the Senate Committee on Governmental Affairs" at 26, 28 ("I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into.") (statement of Louis M. Kauder). See also "Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and Means," 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department).

ance in U.S. regulations for taxpayers and tax administrators to apply in cases where the traditional approaches did not work; (2) lack of an incentive for taxpayers to attempt to set their transfer prices in accordance with the substantive rules; and (3) lack of international consensus on appropriate approaches. To resolve these problems, Treasury has taken the following steps in the last two years:

In July 1994, Treasury issued new final regulations under section 482 of the Internal Revenue Code. These regulations contain methods that were not reflected in prior final regulations: the Comparable Profits and Profit Split Methods. These methods are intended to be used when the more traditional methods are unworkable or do not provide a reliable basis for determining an appropriate transfer price.

In August 1993, Congress enacted a Treasury proposal to amend section 6662(e) of the Internal Revenue Code. This provision penalizes taxpayers that both (1) are subject to large transfer pricing adjustments and (2) do not provide documentation indicating that they made a reasonable effort to comply with the regulations under section 482 in setting their transfer prices. Treasury issued temporary regulations implementing the statute in February 1994.

In July 1994, the Organization for Economic Cooperation and Development issued a draft report on transfer pricing. The United States is an active participant in this body. The OECD transfer pricing guidelines serve as the basis for the resolution of transfer pricing cases between treaty partners and it therefore is critical that any approach adopted in any country be sanctioned in this report in order to reduce the risk of double taxation. The draft report permits the use of the new U.S. methods in appropriate cases.

2. Why shouldn't the United States interpret Article 9 of the tax treaties regarding transfer pricing as permitting other methods of pricing such as the unitary or formulary apportionment method?

If Treasury adopted such an interpretation, it would send a signal to our treaty partners that we were moving away from the arm's length standard to a different, more arbitrary approach. Sending such a signal would be very destructive and, if implemented, would inevitably result in double (and under) taxation due to the fundamental inconsistency between the approach used in the United States and that used elsewhere. Further, adopting such an interpretation would invite non-OECD countries to introduce their own approaches that currently cannot be foreseen, but that could inappropriately increase their tax bases at the expense of the United States and other countries.

3. The consensus regarding transfer pricing methods is currently the arm's length standard. Will the U.S. remain open to the possibility of better or alternative methods without moving to such alternative methods unilaterally?

If it appeared that another approach was superior to the current approach, the U.S. would push for the adoption of this new approach on a multilateral basis so that there would be the necessary international consensus in favor of the new approach.

4. Why does industry support the arm's length pricing method?

Most multinationals are willing to pay their fair share of tax. Their primary concern is that they not be subjected to double taxation. Because the arm's length standard is the universally adopted international norm and the major countries of the world have adopted a consensus interpretation of that standard within the OECD, the risks of double taxation are infinitely smaller under the arm's length standard than under any other approach.

5. A recent GAO report suggested that many foreign corporations are not paying their fair share of taxes. Is Treasury satisfied that these treaties ensure full payment of required taxes?

A tax treaty by itself will not prevent transfer pricing abuses. Rather, the treaty leaves it to the internal rules and practices of the treaty partners to deal with such issues. In the United States, Treasury has taken the measures described above to ensure that foreign—and domestic—corporations pay their fair share of taxes. A tax treaty can make these internal measures more effective, particularly through the exchange of information provisions that enable the U.S. tax authorities to obtain transfer pricing information on transactions between related parties in the United States and the treaty partner. The treaties also facilitate Advance Pricing Agreements that preclude the possibility of double taxation and at the same time ensure that each country receives an appropriate share of the taxes paid by a multinational.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to have a negligible effect on annual Federal budget receipts during the fiscal year 1995–2000 period.

VIII. Explanation of Proposed Treaty

For a detailed article-by-article explanation of the proposed tax treaty, see the "Treasury Department Technical Explanation of the Convention and Protocol Between the United States of America and Ukraine for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Signed at Washington on March 4, 1994."

IX. Text of the Resolution of Ratification

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention between the Government of the United States of America and the Government of Ukraine for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, with Protocol, signed at Washington on March 4, 1994 (Treaty Doc. 103–30); and the Exchange of Notes Dated at Washington May 26 and June 6, 1995, Relating to the Convention between the Government of the United States of America and the Government of Ukraine for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Together With a Related Protocol, signed at Washington on March 4, 1994 (Treaty Doc. 104–11).

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