〈논　문〉

# The Korea-United States Income Tax Convention

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October 20, 1979, marks a significant change in the economic relations between Korea and the United States of America, for it was on that date first tax convention between the two nations came into force.

In adopting a bilateral income tax convention, the two nations placed their tax relations under a regime that is familiar to all of the nations of the industrialized world. There are so many bilateral tax treaties in force today.(1) and they resemble one another so closely that together they may be described with a fair amount of accuracy as a sort of Uniform Code of International Taxation. Like the uniform laws adopted by American states, they differ from one another at various points. These differences will form one of the topics to be discussed in this paper. A second, and far more important, facet of these treaties is that they provide liberal and simple rules of taxation. The liberal and simple rules appearing in this treaty supplant rules of the United States Internal Revenue Code which are neither liberal, nor simple, nor easy for even an American to apply with confidence. Describing the manner in which this process operates is the principal task of this essay.

## 1. IN GENERAL.

**a. Title**—Income tax treaties tend to follow one of several formulae regarding title. The Organisation for Economic Cooperation and Development ("OECD")

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(1) When the OECD Model was published in 1977, it listed 179 bilateral tax conventions in force on that date. The total is significantly larger today.

uses the term "convention... for the avoidance of double taxation with respect to taxes on income and on capital.[2] The Republic of Korea tends to conclude conventions for the avoidance of double taxation "and the prevention of fiscal evasion"[3] and to drop the reference to "capital."[4] Generally it enters into "conventions". In deference to the desires of one of its treaty partners, it entered into an "agreement," instead.[5]

By comparison with the foregoing, the title to this treaty is mildly spectacular: "Convention... For the Avoidance of Double Taxation of Income and the Prevention of Fiscal Evasion and the Encouragement of International Trade and Investment."[6] With no Korean antecedents, one is prompted to look to United States sources for title embellishments. Although a couple of other United States treaties add language to their preambles, the United States treaty with Trinidad and Tobage[7] is the only prior convention of either partner the title to which includes the language "the encouragement of international trade and investment." One may well wonder whether any significance ought to be attached to this peculiarity of labelling.

**b. The Period of Effect**—Article 31 of the Convention brought it into force thirty days after the exchange of instruments of ratification. That thirty-day period expired on October 20, 1979. Limitations on withholding taxes were

(2) Model Double Taxation Convention on Income and Capital (O.E.C.D. 1977), Title of the Convention (hereinafter "OECD Model").

(3) E.g., Korea-Australia, Preamble. Because all Korean treaties are available in (and all, save one, are *official* in) English, references herein should be understood to refer to VB Taxes and Investment in Asia and the Pacific (Int'l Bureau of Fiscal Documentation 1979). Treaties will be cited simply by names of partners.

(4) E.g., Korea-France, Preamble.

(5) Korea-Malaysia, Preamble and Arts. 1, 2(1), 2(2), 3(1), 3(2), 5(1), 25, 26, 27, 28, 29.

(6) Convention Between the United States of America and the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Encouragement of International Trade and Investment, June 4, 1976, 30 U.S.T. 5253, T.I.A.S. No. 9506, 1979-2 C.B. 435. (References to this convention hereinafter will refer only to article numbers: "Art. ").

(7) Convention Between the Government of the United States and the Government of Trinidad and Tobago for the Avoidance of Double Taxation, the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Encouragement of International Trade and Investment, Jan. 12, 1970, 22 U.S.T. 164, T.I.A.S. No. 7047, 1971-2 C.B. 479. (United States tax treaties being accessible in both CCH and P-H tax treaties services, reference to U.S.T. and T.I.A.S. are dispensed with in this article.)

to apply "on or after the first day of the second month following the date on which this Convention enters into force." Thus, withholding is reduced as of December 1, 1979.[8] As to ordinary income tax liability, the convention entered into force on January 1, 1980.[9] The convention will terminate on October 20, 1984, provided that at least six months prior notice of termination has been given through diplomatic channels. The earliest date upon which the effect of the treaty may be ended in accordance with its terms thus becomes January 1, 1985. The chances of its terminating on that date seem minimal.

**c. Effect on United States Tax Law.** § 894 (a) of the Internal Revenue Code provides the basic direction:

> "INCOME EXEMPT UNDER TREATY—Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle."

In the final portion of the Internal Revenue Code, in a subchapter entitled "Effective Date and Related Provisions," in a section headed "Other Applicable Rules," one finds § 7852 (b), which provides

> "TREATY OBLIGATIONS—No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title."

These provisions cannot be accepted at face value. Under the American system, treaties and ordinary acts of Congress are of equal dignity. Congress cannot legislate away its legislative power. Hence, the later of a treaty or a Congressional enactment expresses the posture of the law in any case in which one purports to repeal the other. This has occurred within the past twenty years, most pointedly in the course of enacting the Foreign Investment in Real Property Tax Act,[10] which simply purports, despite §§ 894 (a) and 7852 (b), to override outstanding treaties. As a result, § 897 of the code, dealing

(8) Art. 31(a).
(9) Art. 31(b).
(10) Pub. Law 96-499, §1122(a), 94 Stat. 2599, 2682 (1980).

with the disposition of "United States real property interests" will be effective in the case of residents of Korea, beginning January 1, 1985, unless this Convention is sooner renegotiated.[11]

**d. Source of the Provisions.** —This convention, like all of the tax conventions of the Republic of Korea, has been created on the form of the 1963 OECD Draft Convention. The text of this convention most closely resembles the text of the United States-Japan treaty. The resemblance is no doubt due to the fact that the Japan treaty and the French treaty that preceded it represent the first two American efforts to incorporate into United States treaties the substance of the OECD Draft Convention.[12] By reason of this resemblance, and in view of the similarity of Korean domestic law to that of Japan, it is sensible to suppose that American interpretations of provisions of the Japan treaty would be indicative of the meaning of parallel Korea treaty provisions. Hence, reference to those provisions will be made throughout this paper.

**e. Peculiarities.** —Every tax treaty is idiosyncratic to some degree. This treaty is no exception. Perhaps the most notable provision of that sort in this treaty is an exemption from the payment of social security taxes in respect to temporary Korean laborers employed in Guam.[13] It is the more peculiar because the United States has the right to repeal it unilaterally, simply by repealing a parallel exemption in respect of Philippine workers in Guam that currently appears at § 3121 (b) (18) of the code.

## 2. SCOPE OF THE TREATY: TAXES.

Not all taxes are covered by this treaty. On the Korean side, only the income tax and the corporation tax are covered for most purposes,[14] although

(11) Pub. Law 96-499, §1125, 94 Stat. 2599, 2690 (1980).

(12) See Huston, Working with the Japanese Treaty, in Income Tax Treaties 563, 566 (J. Bischel ed. 1978).

(13) Art. 25.

(14) Art. 1(1)(b). The English version of the treaty, which is official (Art. 32), refers to the juridical persons tax as "the corporation tax." Yu, Analysis of the Korean Tax Treaty, 7

the non-discrimination provisions apply to "taxes of every kind imposed at the national, state or local level.[15] Significantly, the exchange-of-information provisions apply only to national taxes.[16]

On the side of the United States, the treaty is significant with respect to the taxes it does not cover. Covered are "the Federal Income Taxes imposed by the Internal Revenue Code."[17] The United States specifically reserves its right to impose the personal holding company and accumulated earnings taxes, exempting a Korean corporation from the former only if wholly-owned by individual residents of Korea, not citizens of the United States.[18] The want of a permanent establishment in the United States serves to exempt the Korean corporation from United States accumulated earnings tax under the same treaty provision. Korean corporations are otherwise subjected to both taxes, and the treaty makes no mention at all of the provisions of the United States law respecting foreign personal holding companies[19] and controlled foreign corporations.[20]

Plainly, subject to the treaty exception already mentioned, the United States will seek to impose its social security taxes pursuant to the provisions of the Internal Revenue Code.[21] Again, the excise taxes with respect to foreign insurance premiums[22] and private foundations fall[23] outside the purview of the Convention. For the Korean trader, the failure of the United States to cover state and local taxes (in other than the non-discrimination) is typical. The United States government rarely purports to bind the states in a tax treaty

*Int'l Tax J.* 127, 129 (1980). The French treaty is the only Korean tax treaty not authentic English. The treaty does not cover the Korean inhabitant tax, a local tax covered by most of the treaties which the Korean government has entered into with European countries. The inhabitant tax is levied as a surcharge on corporation and personal income taxes at the rate of 7.5 percent.

(15) Art. 1(3).
(16) *Ibid.*
(17) Art. 1(1)(a).
(18) Art. 4(8).
(19) I.R.C. §§551-558.
(20) I.R.C. §§951-964.
(21) I.R.C. §§3101-3111.
(22) I.R.C. §§4371-4374.
(23) I.R.C. §§4940-4948 (foreign organizations are the target of §4948).

(and its most recent attempt was a debacle).[24] As a result, careful state-tax planning becomes essential to the Korean businessman who would engage in business—even as a commercial traveler—in the United States.[25]

The Korean defense tax is not mentioned in the treaty. Levied as a surcharge on a number of Korean taxes, including the income tax and corporation tax that the treaty does cover, its status was apparently anomalous. Clarification came by an exchange of diplomatic notes on the day the treaty was signed. In his response, the Korean minister of foreign affairs assured the United States ambassador that that portion of the defense taxes that was assessed on the income and corporation taxes was indeed covered by the Convention.[26]

In both notes, references are made to further negotiations on the topic of what the minister of foreign affairs calls "provisions...that will minimize the interference of the U.S. tax system with incentives offered by the government of Korea..."[27]

The Korean Foreign Capital Inducement Law provides a five-year tax holiday for corporation tax on the income of approved foreign invested enterprises and on dividends paid to the foreign person's investing in such enterprises, for example. The benefit of such tax incentives is substantially diminished, however, if the United States taxes the dividends declared out of tax exempt income. Therefore, the Koreans have pressed for tax sparing legislation in the United States which would exempt such dividends from United States tax.

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(24) See Human, Tempest over the Treaty, 23 *St. Louis U.L. Rev.* 509 (1979); Levine, Implications of Article 9(4) of the United Kingdom Tax Treaty for State Tax Purposes, 11 *Urban Law* 284 (1979).

(25) The constitutionally-permissible threshhold for state business taxation is far easier to cross than is "permanent establishment." See, e.g., *General Motors Corp. v. Washington*, 377 U.S. 436 (1964).

(26) 1976-2 I.R.B. 446-47. The Korean defense tax is levied as a surcharge on the Korean corporation and personal income taxes. The corporate surcharge is levied at the rate of either 20 or 25 percent; the personal income surcharge is levied at the rate of either 10 or 20 percent.

(27) *Ibid.*

## 3. SCOPE OF THE TREATY: PERSONS.

Tax treaties have as their central mechanism a number of rules that protect residents of one of the contracting states from the tax treatment that would be afforded that resident by the other contracting state in the absence of the treaty. Of course, in the interests of international uniformity, treaty partners often adopt provisions that are less favorable than counterpart provisions in the domestic law of either partner.[28] Again, provisions may have no independent significance because they merely repeat the language of diplomatic conventions, consular conventions, or status-of-forces agreements.[29] Some few treaty provisions actually purport to protect the resident again his, her, or its government.[30] But in general, among industrialized nations, becoming a resident of a treaty partner results in leaving the zone of treaty protection. The definition of "resident" becomes a pivotal concern.

**a. Individuals.**—Treaties divide individuals into four classes on the basis of the national state in which each individual resides. Treaty provisions deal with residents of each of the treaty partners, of neither of the treaty partners, and of both of them. The residence of the individual is determined under his or her domestic tax law.[31]

Special rules for determining residency are provided in one situation. That is the situation in which an individual is a resident of both treaty partners —presumably due of the application by each partner of its own rules. In that instance, the individual becomes the resident of the state in which he maintains his permanent home,[32] or, failing that, the state which constitutes

(28) E.g., the Japanese treaty treatment of gains on stock sales is generally more favorable to the foreign taxpayer than are the provisions of the United States-Japan Convention. See J. Huston, T. Miyatake & G. Way, Japanese International Taxation §§4.02[1][b], 4.02[3] (1983) (hereinafter "Huston, Miyatake & Way").

(29) E.g., Article 26 (Diplomatic and Consular Officers) adds nothing to the exemptions conferred by existing diplomatic and consular conventions. See notes 214 and 215, *infra*.

(30) See Art. 20 (Teachers).

(31) See Joint Committee Report, 1949-2 I.R.B. 447, 449.

(32) Art. 3(2)(a).

the center of his vital interests.[33] If neither of those rules resolve the difficulty, the residency is fixed in terms of habitual abode,[34] then citizenship.[35] If nothing else works, the issue is to be resolved by mutual agreement procedures.[36] But again, the caveat must be stated: by their own terms, these additional rules do not apply unless the individual is regarded as a resident of both states.[37] If either treaty partner regards him or her a resident of a third state, the rules do not apply.

The nationality of the individual is of distinctly secondary importance in most treaties, appearing infrequently in such articles as the "Government Functions" article of this convention. In treaties with the United States, citizenship or nationality is of considerably greater importance by reason of the inclusion of the "saving clause."

**b. Corporations.**—A United States corporation is a resident of the United States.[38] A Korean corporation is a resident of Korea.[39] The treaty states these rules briefly and simply. Explaining their meaning takes a little longer, but the definitions provisions are equal to the task. The United States corporation is a corporation created under the laws of the United States or any state thereof or the District of Columbia.[40] The term also includes the category that Americans call "associations"—the unincorporated entity which United States tax law treats as a corporation.[41]

The treaty provision honors the American rule that divides domestic from foreign corporations on the basis of place of incorporation. One should note that entities incorporated in other American territory—Puerto Rico, Guam, and the Virgin Islands in particular—are not residents of the United States under this definition.[42]

(33) Art. 3(2)(b).
(34) Art. 3(2)(c).
(35) Art. 3(2)(d).
(36) Art. 3(2)(e) (Presumably in accordance with Art. 27.)
(37) Art. 3(3).
(38) Art. 3(1)(a)(i).
(39) Art. 3(1)(b)(i).
(40) Art. 2(1)(e)(i).
(41) *Ibid.* See I.R.C. § 7701(a)(3); Treas. Reg. §301.7701-2 ("associations").
(42) See I.R.C. §7701(a)(4) and (5).

A Korean corporation is a corporation which has its head or main office in Korea.[43] In addition, any other entity treated as a Korean corporation for Korean tax purposes is a resident of Korea.[44] The Korean rule is subject to a single exception: if a corporation is a "United States corporation" it cannot be a "Korean corporation" for the purposes of the treaty.[45] With a fourteen-word parenthetical expression,[46] the drafters of this treaty have avoided the problem that has already arisen under parallel language of the Japanese treaty, and has been resolved in another context against a corporation organized in an American state which had its principal office in Japan.[47] It is still possible that the "association" could be treated as a domestic entity by both treaty partners, by reason of its lack of any place of incorporation at all. The possibility seems extremely remote.

**c. Estates and Trusts.**—Estates and trusts are anomalies in American law. They are entities for tax purposes; they are otherwise simply relationships among individuals.[48] Because the treaty defines the term "person" to include estates and trusts,[49] they may be residents of either treaty partner. The treaty provides that the term "resident" includes any other "person" which the respective governments treat as residents for tax purposes, "but in the case of a person acting as a partner or fiduciary only to the extent that the income derived by such person is subject to [domestic law] tax as the income of a resident."[50] The exception appears to limit treaty taxation to items of income retained by the fiduciary, rather than being distributed to beneficiaries.

**d. Partnerships.**—While the United States-Japan Convention upon which

(43) See Baskerville & Kim, Business Operations in the Republic of Korea, (Tax Management Portfolio in press).
(44) Art. 3(1)(b)(ii).
(45) *Ibid.*
(46) "(except a corporation or an entity treated under United States law as a corporation)".
(47) See Huston, Miyatake & Way, §1.03[2] (1983).
(48) See Huston, Transfers to the "Estate" of a Named Person, 15 *Syracuse L. Rev.* 463 (1964), reprinted Landmark Papers on Estate and Trusts 622 (A. Winard ed. 1968).
(49) Art. 3(1)(a)(ii), 3(1)(b)(ii).
(50) *Ibid.* See IRC §§651, 661.

this treaty is modelled appears to omit partnerships from its coverage,[51] this treaty plainly deals with them. It states that they are included within the term "person"[52] and, as just mentioned, limits application of the treaty to the partner's distributive share.[53]

The first paragraph of the fiscal domicile article concludes with a provision appearing nowhere else in Korean tax conventions (which is absent from the United States-Japan tax Convention as well.) It states:

> "In determining the residence of a partnership which makes a payment, a partnership shall be considered a resident of the State under the laws of which it was created or organized."[54]

The partnership to which the provision refers and the type of payments made are pieces of the same puzzle. Were the payments interest? An amount realized on the sale of capital assets? Royalties? To whose withholding system or foreign tax credit is the provision actually addressed?

Although the Senate Report declines to recognize this issue,[55] the Treasury Department technical explanation explains the provision with relative candor:

> "This paragraph is to be used in the determination of the source of interest. Thus, if a partnership organized in the United States pays interest to a resident of Korea, the source of the interest would be the United States even if none of the partners are residents of the United States."[56]

**e. "Bodies of Persons."**—The treaty defines "person" to include "an individual, a partnership, a corporation, an estate, a trust, or any body of persons."[57] From the standpoint of American law, the taxpayer or taxpayers to which the last clause refers is an unincorporated association. Not all unincorporated

(51) See Technical Explanation of the United States-Japan Tax Convention, 1973-1 C.B. 653, 655 (hereinafter cited to Cumulative Bulletin page, *e.g.*, "Tech. Ex. 655").
(52) Art. 2(1)(d); see text at notecall 50.
(53) Art. 3(1)(a)(ii), 3(1)(b)(ii).
(54) Art. 3(1)(c).
(55) Sen. Ex. Rept. No. 96-7, reprinted at 1979-2 C.B. 447, 449 (hereinafter cited, e.g., "Sen. Rept., 449").
(56) Tech. Ex., 1979-2 C.B. 458, 459.
(57) Art. 2(1)(d).

associations will fall within this category, however, some being taxed as "an entity treated under United States law as a corporation."[58] The latter becomes under the treaty network of definitions, a "United States corporation" for all purposes of the treaty.[59] The likelihood that the remaining unincorporated associations will have any significance in United States-Korea tax relations is very, very scant.

## 4. SCOPE OF TREATY: TERRITORY

Just who *are* these United States of America of which the treaty speaks? And who *is* Korea? The parties to the treaty define themselves in two ways. The first and the non-geographic definition is redundant: "'United States' means the United States of America"[60] and "'Korea' means the Republic of Korea."[61]

The geographic definition is considerably more meaningful. "'Korea' means all the the territory in which the laws relating to Korean tax are enforced."[62] This is an expansible definition, seemingly drawn directly from the United States-Japan Convention.[63] The Japanese counterpart has already expanded in one instance, and brought Okinawa beneath the treaty umbrella when Japanese tax laws again became applicable to it.[64]

When used in the geographic sense, "the United States" does not mean all of the territory to which United States tax law may be applicable. It applies only to the fifty states and the District of Columbia,[65] leaving all the rest of the United States territory—Guam, Puerto Rico, and the Virgin Islands in

(58) Art. 3(1)(a)(ii).
(59) Art. 2(1)(e)(i).
(60) Art. 2(1)(a)(i).
(61) Art. 2(1)(b)(i).
(62) Art. 2(1)(b)(ii).
(63) Japan-United States Art. 2(1)(b).
(64) It is rumored that a number of permanent residents of Okinawa who regularly conducted business in Japan hastily moved elsewhere to avoid becoming taxable in Japna, as permanent residents, on their worldwide income.
(65) Art. 2(1)(a)(ii).

particular—outside of the treaty. The areas omitted are treated in a special American tax regime, one of the facets of which is treating them as if they were foreign countries for a number of tax purposes.[66]

The geographic definitions include specifically the territorial seabed of each of the nations[67] and the natural resource exploitation area beyond.[68] The territorial seas and exploitation areas of the American "other areas," are probably omitted from treaty coverage.[69] Thus it becomes possible for a resident of one of the contracting states to acquire a permanent establishment in the other contracting state by erecting an oil rig on the continental shelf, a hundred miles from the shore.[70]

## 5. PERMANENT ESTABLISHMENT

When a tax treaty is in place, taxpayers, foreign and domestic, are divided into six principal classes. The individual resident of the taxing jurisdiction constitutes the first class. He or she is taxable by the nation of residence, on his or her entire world-wide income. Domestic corporations constitute the second class. Their fate is the same as that of resident individuals—taxation of their entire world-wide income. As to both classes, the treaty insists that the domestic jurisdiction allow a credit against the domestic tax in an amount equal to the tax levied by the treaty partner on items of income having their source within that partner.[71]

Nonresident individuals and foreign corporations comprise the next two classes. They are taxed on compensation for personal services rendered and on passive investment income from sources within the domestic jurisdiction.

(66) See, e.g., IRC §931.
(67) Art. 2(1)(a)(ii)(A), 2(1)(b)(ii)(A).
(68) Art. 2(1)(a)(ii)(B), 2(1)(b)(ii)(B).
(69) The term "thereof," in Article 2(1)(a)(ii)(B) ("...the coast thereof...") probably refers back to "the states thereof and the District of Columbia" in Article 2(1)(a)(ii)—rather than to "United States"—the referent of "the states thereof".
(70) See Art. 9(2)(g) ("A ... place of extraction of natural resources" is a "fixed place of business").
(71) E.g., Arts. 4 and 5.

They are not, without more, taxed on their business profits (or "industrial or commercial profits"—this treaty uses both terms.[72]

The last two classes of taxpayers are nonresident individuals and foreign corporations having permanent establishments in the jurisdiction. When a nonresident individual or foreign corporation has a permanent establishment in either of the treaty countries, that country has the privilege of taxing its industrial or commercial profits from sources within the country to the extent that such profits are attributable to the permanant establishment.[73]

The permanent establishment concept centers on a "fixed place of business." The most authoritative definition of the concept "contains the following conditions:

—the existence of a 'place of business', i.e. a facility such as premises or, in certain instances, machinery or equipment;

—this place of business must be 'fixed', i.e. must be established at a distinct place with a certain degree of permanence;

—the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated."[74]

**The Fixed Places.**—Article 9 begins with the simple statement that permanent establishment "means a fixed place of business through which a resident of one of the Contracting States engages in industrial or commercial activity."[75] The language is that of the United States-Japan treaty, as is the language of the next paragraph which clicks off a number of "fixed places of business,"

(72) E.g., Art. 8(1).

(73) See, e.g., Art. 8(2).

(74) OECD Model Commentary 59. See Williams, Permanent Establishments in the United States, 29 *Tax Law* 277, 308 (1976); reprinted in Income Tax Treaties 189, 194 (J. Bischel ed. 1978). An important, albeit elementary, observation underscores a major difference between the nonresident-with-permanent establishment and the foreign-corporation-with-permanent establishment. The latter does not alter its status no matter how long it operates or how much business it transacts. The former, on the other hand, may easily become a resident —and thereafter be taxed outside of the purview of the tax treaty.

(75) Art. 9(1).

beginning with a branch, and ending with a construction project.[76] As to the latter, the 24-month period of the Japanese treaty is reduced here to the 6-month period common in treaties with developing nations.[77]

The paragraph following contains an almost-conventional list of exceptions to the foregoing rules. Here are listed the use of facilities or the maintenance of a stock of goods for storage, display, delivery, or processing.[78] Excepted also are places maintained for the mere purchase of goods, the collection of information[79] or for preparatory or auxiliary activities.[80] These are drawn directly from the Japanese treaty, redrafted to provide a grammatical redundancy not present in the original. In a unique and sensible provision, this treaty states that a building site or construction or installation project which does not exist for the required six months is not a "fixed place of business."[81] The proposition is assumed with respect to counterpart provisions in other treaties; here it is stated flat out.

Paragraph (5) of the article is unusual. It provides that a fixed place of business in a host jurisdiction, plus goods or merchandise, either processed in that jurisdiction by a third person or purchased in that jurisdiction, will produce permanent establishment in that jurisdiction, if all or part of the goods or merchandise is sold by or on behalf of the resident for use, consumption, or disposition in that jurisdiction."[82]

It is conceptually possible to combine the home-office sale with the "storage, display, or delivery" exception under other treaties and avoid thereby a finding permanent establishment. Whether it is a practically viable of conduct under such treaties may be questioned.

**Agency-Permanent Establishment.**—This convention contains the usual declaration that the dependent contracting agent constitutes a permanent establish-

(76) Art. 9(2).
(77) Art. 9(2)(h).
(78) Art. 9(3)(a), (b), and (c).
(79) Art. 9(3)(d).
(80) Art. 9(3)(e).
(81) Art. 9(3)(f).

ment. The statement provides that the rule does not apply to the contracting agent who is merely a purchasing agent.[83] That language suggests, of course, that agents having contracting power is respect of storage, display, advertising, research, and all the rest of exempt activities fall into a different category.[84] This is most unlikely, but one cannot be faulted for suggesting the point.

The United Nations Draft Model Double Taxation Convention between Developing Countries supplies the next proposition—that an agent who "maintains...a stock of goods or merchandise belonging to(the nonresident individual or foreign corporation) from which he regularly fills orders or makes deliveries" will himself constitute a permanent establishment, even though he has no power to contract, at all.[85]

One must underscore the fact that agency-permanent establishment requires actual dependency. Neither the contracting agent not the order-filling agent is a permanent establishment under the treaty if he is a "broker, general commission agent or...other agent of an independent status...acting in the ordinary course of his business."[86]

In arriving at determinations under these agency-permanent establishment rules, the taxing official is required to disregard other economic units present

(82) Art. 9(5).

(83) Art. 9(4)(a).

(84) The draftsmen of the treaty virtually suggest this odd possibility. Article 9(3) deals on its face with fixed places of business when they are used "only for one or more of the following." Article 9(3)(d) lists, "The maintenance of a fixed place of business for the purpose of purchasing goods or mechandise, or for collecting information, for the resident." That is the effect of the use of the fixed place of business; what is the effect of the employment of a dependent contracting agent for collecting information? Article 9(4)(a) permits that sort of thing only in the case of a purchasing agent and only when that agent's authority is limited to purchasing for the account of the principal (and not, for example, for the account of a parent or subsidiary of the principal). Result? The current treaty negotiators ought not be faulted for this drafting. It is a quarter-century old. See 1st Report of the Fiscal Committee of the O.E.E.C. on the Elimination of Double Taxation 33 (the provision), 51-52 (the commentary) (1958).

(85) United Nations Draft Model Double Taxation Convention Between Developed and Developing Countries, Art. 5(5), (Int'l Fiscal Ass'n ed. 1979).

(86) Art. 9(6) As one author observes, the tough UN rule that would have an agent deemed dependent if he acts "almost wholly" on behalf of the principle, even if he does so in the ordinary course of his business, UN Draft Model Art. 5(7) (last sentence), was not adopted in this treaty. Amador, The Korea-U.S. Income Tax Treaty and the Third World, 80-3 Tax Mgmt. Int'l J. 11, 12 (1980).

in the host country that may be related to the putative principal.[87] The units contemplated include subsidiary domestic corporations, foreign subsidiary corporations with local permanent establishments, and foreign subsidiaries operating locally which have not acquired permanent establishment.[88]

But the treaty speaks of "residents". "Residents" includes individuals. How these rules are to apply to individuals is, frankly, puzzling.

**Rules for Third Country Residents.**—The final paragraph of Article 9 of the treaty declares that the foregoing principles should be used to determine whether there is a permanent establishment in the third country or whether a third country person has a permanent establishment in one of the treaty states.[89] The provision does not appear in either the UN Draft Treaty, the OECD Model, or the United States Model. The technical explanation of the treaty opines that the provision "is necessary for the proper application of the source-of-interest income rules and is not intended to extend treaty benefits to third-country residents."[90]

## 6. INCOME-SOURCE RULES

**The Function of Source Rules.**—The basic structure of a treaty such as this is relatively straightforward. Each of the treaty partners taxes residents of the other treaty partner on items of income which are said to have their "source" within the territory of the first treaty partner.[91] These items must be taxed under a scheme that does not discriminate against the foreign taxpayer.[92] Items of passive investment income, apart from those involved in the active conduct of business through a permanent establishment, are typically subject

(87) Art. 9(7).
(88) Art. 11(2).
(89) Art. 9(8).
(90) Tech. Ex. 484. The Technical Explanation refers to Article 6(2), taking interest source into a third country when a treaty-country-resident maintains a permanent establishment in the third country, and the interest is "borne by" that permanent establishment.
(91) Art. 4(1) (General Rules of Taxation").
(92) Art. 7 ("Nondiscrimination").

to maximum rates of taxation applied to the gross receipts of the foreign taxpayer (irrespective of the method of tax employed or of the actual rates of tax applied).[93] "Source" thus becomes a pivotal concept, because it identifies those items of income that each treaty partner is free to tax subject to limits on the amount of tax that each may exact on some of the items identified.[94]

**The Rules Themselves.**—The rules enunciated in this treaty are quite conventional: "dividends shall be treated as income from sources within a Contracting State only if paid by a corporation of that Contracting State."[95] Obviously this first rule puts a burden on the word "of". Because "of" must refer to the Article 2 definitions of "United States corporation" and "Korean Corporation."[96] this form of drafting means that dividends have their source in the United States when declared by a company incorporated in the United States, a state, or the District of Columbia; and have their source in Korea when declared by a corporation (other than a United States corporation) which has its head or main office in Korea.

Interest generally has its source in a country if paid by a governmental unit or a resident of that country. The source may shift to a permanent establishment abroad maintained by the resident of that country if the debt and the debt service are connected closely enough with that permanent establishment.[97]

Royalties are sourced in the place at which the property or rights producing the royalties are said to be used. This treaty makes an exception favoring ship and aircraft rentals.[98] The Japanese treaty contains a reference to a capital gains that is excised from this treaty.[99] The excision appears to have no substantive effect.

Income from real property, mineral royalties, and gains derived from the

(93) See, e.g., Articles 12 ("Dividends") and 14 ("Royalties").
(94) See generally, Rules for Determining Income and Expeses as Domestic or Foreign, 65b Cahiers de droit fiscal international (Studies on International Fiscal Law) (1980).
(95) Art. 6(1).
(96) Art. 2(1)(e)(i); 2(1)(e)(ii).
(97) Art. 6(2).
(98) Art. 6(3).
(99) Japan-United States, Art. 6(3).

sale of interests in realty have their source in the country in which the realty is situated.[100]

Tangible personalty produces income in the state in which the personalty is situated. Ships and aircraft do not respond to this rule very well, hence those engaged in intra-national traffic produce income at the country of residence of the lessee.[101] The treaty contains no rule for the income arising out of leases of ships or aircraft moving in international traffic.[102]

Income from rendering one's own personal services or supplying the personal services of others is said to arise at the place in which the service is actually rendered.[103] Deferred private compensation is included within the rule.[104] Ships' companies and aircrews engaged in international traffic are subject to a special rule, sourcing their compensation in the countries of residence, respectively, of the operators of such ships and aircraft.[105] The rule common to a number of treaties which makes the source of a director's compensation the country of which his corporation is a resident[106] has been deleted from this convention.

The purchase and sale of personal property generally produces income having its source at the place of sale.[107] The provision is likely to have the same problems as has its counterpart in the Japanese treaty. American and Japanese rules respecting the place of sale of ordinary merchandise differ approchably. Those involved in purchasing goods in one country and selling them in another

(100) Art. 6(4).
(101) Art. 6(5).
(102) The reason is doubtless the exemption from tax appearing at Article 10. Income from the inland transportation of containers does not share the exemption. Art. 10 (second sentence). The source of this income is problematic.
(103) Art. 6(6).
(104) Id. (third sentence). More accurately, private pensions under Article 23 follow the rule. Goverment pensions and social security payments are sourced in the payor jurisdiction. In Korea, the issue is probably of little moment, for the provisions taxing pensions seem to operate without reference to source. But the "saving clause" may reach income in the hands of American recipients—who will then need foreign-source findings if the credit is to be available.
(105) Art. 6(6) (second sentence).
(106) See, e.g., Japan-United States, Art. 6(6) (last sentence).
(107) Art. 6(7).

can, with only a little carelessness, consummate sales producing income regarded by each of the countries as having a domestic source.[108]

The final source rule is the one that calls all of the others into question. It states that, all of the foregoing rules to the contrary notwithstanding, "industrial or commercial profits which are attributable to a permanent establishment which the recipient, a resident of one of the Contracting States, has in the other contracting state... shall be treated as income from sources within the other contracting state." For this purpose "industrial or commercial profits" includes all forms of passive investment income "if the property rights or rights giving rise to such income... are effectively connected with such permanent establishment..."

It takes only a moment's reflection to determine that this final paragraph deals with foreign-source income—that is, income which, after the application of all of the rules mentioned earlier, emerges as income having its source outside of the territory of the treaty partner imposing the tax. The effect of the final paragraph is simply to domesticate a source of income that would otherwise be foreign. It may not be improper to suggest at this point that the "source" concept is circular. Is there any difference between the proposition that Korea may tax Korea-source income, and the concept that "Korea-source income" is a convenient way of describing all of the income that, as a matter of international accord, Korea may properly tax?[110]

## 7. BUSINESS PROFITS

**The Basics.**—One of the primary rules of treaty taxation is the rule that the purchase of goods in one country and their sale in another does not produce

(108) See Huston, Miyatake & Way §3.03[8].

(109) Art. 6(8).

(110) See Patrick, General Report, op. cit. supra note 94, at 15, 34. ("A further observation from the reports is that there are not many principles to be drawn upon for concluding that one rule of source is right and another is wrong although some seem more easily administrable than others.")

income taxable in that other country unless the seller has effected more than a minimum level of penetration into the domestic economy of the other country. In the actual treaty context, the rule is expanded in several directions. The purchase and sale of goods creates "business profits" or "industrial or commercial profits"—and is the first entry on a list of items that varies from treaty to treaty.(111) The minimum level of penetration subjecting business profits to the tax becomes "permanent establishment."(112) Minimum penetration alone no longer pulls in all domestic-source income; the treaty requires that income be "attributable to" the permanent establishment if it is to be taxed.(113) The tax is not imposed on gross receipts. Deductible expenses are subtracted in arriving at the tax base.(114) Finally, passive investment income is included in the tax base to the extent that the property giving rise to the income is "effectively connected with" the permanent establishment.(115)

**Variations.**—On this standard pattern only a couple of variations appear in the Korean treaty. First of all, there are separate definitions of "industrial or commercial activity"(116) and "industrial or commercial profits".(117) The former is used to delineate the sort of endeavor producing the "active" component of income subject to this general treatment; the latter lumps this active "income derived from industrial or commercial activity" with the "effectively-connected" passive investment income. The "active" category covers income from the conduct of "manufacturing, mercantile, insurance, banking, financing, agricultural, fishing, or mining activities, the operation of ships or aircraft, the furnishing of services and the rental of tangible personal property (including ships or aircraft.)" It differs from the parallel category in the United States-Japan convention by its inclusion of banking and financing activities and the

(111) See de Ravel d'Esclapon, International Tax Treaties and Industrial and commercial Profits, in Income Tax Treaties 75 (J. Bischel ed. 1978).
(112) See Williams, Permanent Establishments in the United States, id. at 189, reprinting 29 Tax Law. 277(1976).
(113) See Art. 8(1) (last sentence), 8(2).
(114) Art. 8(3).
(115) Art. 8(6).
(116) Art. 8(5).
(117) Art. 8(6)(a).

rental of ships and aircraft.[118] A number of items appearing elsewhere—for example, film rentals, management fees, and knowhow payments—are absent from the list.[119] The treaty specifies that income from furnishing the personal services of other individuals falls within the category, and income from furnishing one's own services falls outside of it.[120]

The combination of this provision and the permanent establishment provision means, from the standpoint of the Korean resident, that the minimum level of business to be conducted in the United States without federal tax consequences moves from the vague, court-made "engaged-in-trade-or-business" threshold of the Internal Revenue Code[121] to the international "permanent establishment" standard. Moreover, the limited force-of-attraction principle, which subjects all United States-source income (other than passive investment income) to graduated income tax at domestic rates, once a foreigner is found to be engaged in trade or business,[122] is supplanted by the attributable-income requirements of the tax treaty. More important than any of the foregoing to the private investor is obtaining treaty maximum tax rates on passive investment income. While it seems highly unlikely that any sophisticated investor would be paying American domestic-law taxes at 30% of gross revenue,[123] favorable treatment is now at hand for a substantial number of items without recourse to third-country corporations.

## 8. INVESTMENT INCOME

It is fairly common among contemporary industrialized nations to divide the income of foreigners into two classes, and to tax one quite differently from

(118) See Japan-United States, Art. 8(5).
(119) See de Ravel d.Esclapon, note 111, supra.
(120) Art. 8(5).
(121) See I.R.C. 871(b), 882(a)(1), 871(c). See S. Roberts & W. Warren, U.S. Income Taxation of Foreign Corporations and Nonresident Aliens ch. v (1966).
(122) I.R.C. §871(a) (1), 881(a), 1441(a).
(123) See, e.g., Kingson, The Coherence of International Taxation, 81 *Colum. L. Rev.* 1151, 1275 (1981).

the other. Income arising from the active conduct of trade or busrness is exempt from taxation in the absence of domestic taxing nexus[124] and is subject to a graduated net income tax if nexus is present[125]. Passive investment income is subject to a gross receipts tax in the 20%[126]-30%[127] range, collected by means of a withholding mechanism[128]. Income from personal services rendered is exempt when earned during brief sojourns,[129] gross-receipts taxed during longer visits,[130] and graduated-net-income taxed when services are produced on a more regular basis.[131] Collection of both gross receipts tax and graduated net income tax by withholding is common.[132]

Treaty taxation tracks this model. In the case of the rents and profits from realty, the leasing of tangible personalty, royalties from licensing intangibles, interest, dividends, and capital gains, a bifurcated treatment appears. Those of the foregoing items that are regarded as "effectively connected with a permanent establishment" are treated in the same way as is ordinary business income.[133] In the typical case, they constitute additional items of income subject to graduated net income tax along with the permanent establishment's items of true business income. Of course, the treaty does not impose the tax. It simply advises that the host country may impose tax on so much of these items as are attributable to a permanent establishment—the permanent establishment being regarded as a "independent entity" for these purposes.[134]

When determining whether these items are to be taxed in this fashion, one is required to determine whether the property or rights giving rise to them are "effectively connected with a permanent establishment." Article 8(6) (b)

(124) See, e.g., I.R.C. §882(a)(1), 864(c)(1).
(125) E.g., I.R.C. §882(a)(1).
(126) E.g., Japan Income Tax Law, arts. 170, 179.
(127) E.g., I.R.C. §881(a).
(128) E.g., I.R.C. §1441(a).
(129) See, e.g., I.R.C. §864(c) (3).
(130) See, e.g., Japan Income Tax Law, arts. 161(8), 164(1)(4), 164(2)(2).
(131) See, e.g., Japan Income Tax Law, arts. 161(8), 164(1).
(132) See, e.g., I.R.C. §1442.
(133) Art. 8(6). See text, infra, at notecall 115.
(134) Art. 8(2).

of this treaty states:

> "To determine whether property or rights are effectively connected with a permanent establishment, the factors taken into account shall include whether the rights or property are used in or held for use in carrying on industrial or commercial activity through such permanent establishment and whether the activities carried on through such permanent establishment were a material factor in the realization of the income from such property or rights. For this purpose, due regard shall be given to whether or not such property or rights or such income were accounted for through such permanent establishment."

The placement of the provisions here, in the business profits article, seems much more appropriate than its position in the last paragraph of the source-of-income rules—as it appears in the Japan-United States treaty,[135] and whence it was transplanted.

To the extent that these items are not regarded as effectively-connected, they are subject to the tax limits set out in articles 11 through 16 of the treaty. On the semantic level, the same treatment should be available to items of this category that arise from rights or property that are effectively connected with the permanent establishment, but are nevertheless not "attributable to" the permanent establishment.[136] At the practical level, and in the absence of a treaty definition of "attributable to", one can express doubt that any such item may in fact exist.

A great many items of the other category do exist. Their treatment will be examined in the paragraphs which follow.

**a. Dividends**—Isolating its application to dividends outside of the effectively-connected category,[137] article 12 of the treaty requires that a country limit its income tax on dividends having a source within it to 15% of their gross amount. If the recipient is a corporation, the recipient owns the 10% or more of the voting shares of the paying corporation, and not more than 25% of

(135) Japan-United States, Art. 6(8).
(136) Art. 8(1) 8(1) (second sentence).
(137) Art. 12(2).

the paying corporation's gross income consists of interest or dividends, the maximum tax rate is 10% of the gross amount.[138]

One should note here, regarding these passive income items, that what is called in the trade a "treaty withholding rate" (in this case, the 15% or 10% rate) has no necessary connection with withholding. The treaty simply fixes a tax limit at a percentage of gross revenue. Whether country imposes a gross receipts or graduated net income tax, and whether it collects its tax by withholding or by means of voluntary returns, is of no importance. Article 12 makes no mention of withholding, at all. And neither do the remaining articles in this category.[139]

**b. Interest.**—The interest provisions of this treaty are the same as those in the United States-Japan convention with a single significant change. The maximum rate of gross receipts tax by the host country was 10% in the Japan treaty.[140] This convention raises the rate to 12%.[141]

Again, the elaborate two-pargraph provisions exempting interest inuring to the Bank of Japan and the Federal Reserve or Export-Import Banks, respectively, in the Japan treaty[142] are compressed in size and expanded in scope in a single paragraph. Interest beneficially derived by any governmental unit, the central bank, or the instrumentalities of either is exempt from taxation by the other treaty partner.[143] The treaty provision closes with a definition of "interest" that is probably adequate for the vast majority of cases.[144]

**c. Royalties.**—The provisions of this treaty dealing with royalties contains some drafting that merely tidies up the provisions earlier appearing in the United States-Japan convention. The specific exclusion from the "royalties"

(138) Art. 12(1). The effective rater should include the inhabitant Tax surcharge, discussed above at note 14, Thus the effective rate is actually 10.75 percent, instead of 10 percent, for example.
(139) The term does appear in Article 32 ("Termination").
(140) Japan-United States, Art. 13(4).
(141) Art. 13(2).
(142) Japan-United States, Art. 13(2) and (3).
(143) Art. 13(3).
(144) Art. 13(6). The treaty omits a definition of "dividends". A definition of the term does appear in the Korea-West Germany Convention Art. 10(4), signed six months later.

category of mineral royalties is an example of this sort of drafting.[145] (Supplanting the term "know-how" with the phrase "knowledge, experience, or skill (know-how)"[146] is arguably not.)

Treaties tend to divide royalties into three categories. The first consists of payments for the use of intangibles and (if the item does not fall within the more favorable business profits provisions)[147] the income from equipment leasing, together with gains from the disposition of either category of property for contingent consideration.[148] A second common category asserts the independent-entity principle by limiting favorable treatment to that portion of royalties paid between related persons which would have been paid under similar circumstances between unrelated persons.[149] The third category simply carves out from this treatment that portion of royalties which may be said to arise from effectively-connected rights or property. These, as has earlier been mentioned, are taxed in the recipient's ordinary income.[150]

The Korean convention contains a provision which divides the first category into two parts. Royalties arising from literary, dramatic, musical, or artistic work, and royalties arising from radio or television films and tape, are subject to a tax ceiling of 10%.[151] The ceiling on taxation of all other royalties is 15% of the gross income from such royalties.[152] This latter category consists of "consideration for the use of, or the right to use... patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights, or knowledge, experience, or skill (know-how), or ships or aircraft..." and gain from the disposition of most items of royalty property to the extent contingent.[153]

(145) Art. 14(4)(b) (final paragraph).
(146) Art. 14(4)(a).
(147) See de Ravel d'Esclapon, International Tax Treaties and Industrial and Commercial Profits, in Income Tax Treaties 75, 91 (J. Bischel ed. 1978).
(148) Art. 14(4).
(149) Art. 14(5).
(150) Art. 14(3).
(151) Art. 14(2).
(152) Art. 14(1).
(153) Art. 14(4)(a).

The division of royalty income into these two general classes occurs in number of United States tax treaties. In the older treaties, the norm seems to have been exemption of royalties other than film rents.(154) The result from the American side in such treaties is taxation of film rents at 30% and taxation of other royalties at zero percent—just the opposite of this plan. One need look no further than the Korea-Belgium treaty to see more of the same: "10 per cent of the gross amount of royalties in the case of industrial investment and... 15 per cent of the gross amount of such royalties in all other cases" constitutes the operating maxima.(155) Neither the joint committee report nor the technical explanation volunteer any information regarding the pattern that appears here.

**d. Incom from Realty.**—Income from real property, however designated, is taxable in the state in which the real property is located at internal tax rates.(156) Earlier United States treaties provided that owners of real property might have the right to elect to have their real property taxed on a "net income" basis.(157) In view of the advent of the Foreign Investors Real Property Tax Act, the absence of from this treaty of one such provision is thoroughly understandable. The result is that the foreign owner of United States real property must make the "net income" election pursuant to the provisions of United States internal tax law. One of the more onerous of these provisions denies the right that foreigner had commonly enjoyed under treaty provisions to select net taxation or gross income taxation on a year-year basis.(158)

**e. Capital Gains.**—Capital gains are exempt from taxation by the host country.(159) The rule is subject to two major sorts of exceptions. The more obvious of the two purports to tax gains too closely associated with economic penetration into the host jurisdiction. This occurs in three contexts. The first of

(154) See, e.g., Unites-Australia., Art. X (155) Korea-Belgium, Art. 12(2).
(156) Art. 15(1).
(157) E.g., Former United States-United Kingdom, Art. IX(1).
(158) I.R.C. §§871(d), 882(d).
(159) Art. 16(1).

these is the usual gain arising from the disposition of property effectively connected with a permanent establishment.[160] Another (being the first appearance in this discussion of that peculiar concept) provides parallel treatment for property effectively connected with something called a "fixed base."[161] The last of these provisions, drawn from the Internal Revenue Code,[162] taxes gains when the recipient is present in the host jurisdiction for more than a hundred eighty-three days in the taxable year.[163]

Somewhat more obscure and plainly more dangerous is the provision excepting, from the exempt class of transactions, gains from dispositions of real property.[164]

It is important again to observe that this provision is overridden by the express terms the United States Foreign Investment in Real Property Tax Act ("FIRPTA"). The basic content of FIRPTA is that treaty exemption is not available for gains arising in the United States from dispositions of interests in real property.[165] Reading the treaty language just discussed, the uninitiated would wonder how it was that the treaty exemption was obtained in the first place. After all, the language of the treaty allows the Americans to tax gains from the sale of real property, does it not?

One responds that the simplest means of obtaining the exemption is by incorporating the real property and selling the stock. Land is real property; corporate shares are not. Because of the ease of circumventing the treaty in this fashion, section 897 of the Internal Revenue Code goes to considerable lengths to make certain that such a disposition of shares does indeed fall within the taxable category. More important still is the FIRPTA provision overriding outstanding treaties.[166] Thus, if the capital gain occurs in the United States and has the effect of disposing of interests in real property,

(160) Art. 16(1)(b), 16(2).
(161) Art. 16(1)(c)(i).
(162) I.R.C. §871(a)(2).
(163) Art. 16(1)(c)(ii).
(164) Art. 16(1)(a), 16(2).
(165) I.R.C. §897(a)
(166) Pub. L. 96-499, §1125(c).

article 16 of this convention cannot be safely relied upon.

In the view of the other treaty partner, and despite assurances to the contrary,[167] there is concern that Korean tax authorities are no more comfortable with the concept "capital gains" that are their Japanese counterparts.[168]

**f. Investment or Holding Companies.**—Article 17 purports to deny the benefits of the dividends, interest, royalties, and capital gains provisions to foreign corporations owned by persons more than 25% of whom are not residents of the treaty partner. It is effective only if

> "By reason of special measures the tax imposed on such corporation by the first-mentioned Contracting State with respect to such dividends interest, royalties or capital gains, is substantially less than the tax generally imposed by such contracting state on corporate profits...[169]

The joint committee report and the technical explanation both explain that the provision is designed to prevent "treaty-shopping".[170] The technical explanation volunteers that the provision is not applicable to capital gains.[171] The joint committee report confesses that as of June 15, 1979, it did not apply at all.[172]

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(167) See Coleman, Taxation of Capital Gains in Japan and Korea in Light of the Concept of Taxable Income, in Current Legal Aspects of Doing Business in Japan and East Asia 253 (J. Haley ed. 1978).

(168) Some displeasure at the lack of a definition of the term in the Japan-United States Convention is voiced in Komatsu, The 1971 Income Tax convention Between Japan and the United Stated States of America, 7Law in Japan: An Annual 51, 67(1974). An extensive discussion entitled "The Definitions of Capital Gains in Various Countries" appears as 61b Cahiers de droit fiscal international (Studies in International Fiscal Law) (1976).

(169) Art. 14(a).

(170) Joint Committee Report 453.

(171) Tech. Ex. 467.

(172) Joint Committee Report 453.

But the Korean tax authorities have taken the position that the U.S. capital gains tax constitutes a "special measure" and that because a subsidiary is owned by a corporation, it is not owned by an "individual resident" of the the United States. The results were disastrous for one U.S. oil company. See Freud, "Treaty Shopping and the 1981 U.S. Treasury Draft Model Income Tax Treaty," 82-4 Tax Management International Journal at 7 (April, 1982).

## 9. INCOME FROM PERSONAL SERVICES

**a. Routine Provisions.**—Here again, understanding treaty provisions may turn on recognizing theoretical groupings. American law probably does a worse job than most in effecting the first grand division of items of personal service income. Japanese law recognizes, for example, that corporations cannot themselves render personal services.[173] Rather, they may supply the personal services of individuals. The grand division, then, is between income derived from supplying the personal services of others and income from rendering personal services oneself. The former income is industrial or commercial profits under this treaty,[174] and will be taxable as ordinary business profits or be entirely exempt, depending upon the existence of a permanent establishment in the home country and the relation of these items to that permanent establishment.[175]

Treaties then divide and subdivide the income according to several standards. Was the person who engaged in the economic activity an employee? If so, was he a student? a trainee? a teacher? a professor? a director of the corporation? a performing artist? Was the compensation current or deferred? If the payer is a government, is the payee a diplomat? a consular officer? a pensioner? Answering these questions in each case makes this final substantive area a rather complex one. It merits at least brief exploration.

**b. Independent Personal Services.**—The "performance of personal services in an independent capacity" are exempt from taxation in a host country unless the person rendering those services is physically present in that host country for 183 days or more during the taxable year or maintains something called a "fixed base" for the same period of time.[176]

(173) See Huston, Miyatake & Way 3.02/1/ /b/ and /h/.
(174) Art. 8(5) and (6).
(175) Art. 8(1) and (2).
(176) Art. 18(2).

If one may be permitted a commonplace, one might point out that the provisions set out in this treaty delimit a period for presence or maintenance of fixed base that is just one day shorter[177] than that that appears in the Japanese treaty, from which it is obviously drawn.[178] And, for that matter, one day longer than that delimited in Korea's treaty with Belgium.[179] The observation is submitted merely to remind practitioners that the draftsmen of tax treaty time limitations have fallen into the nasty habit of producing one-day variations in otherwise-identical provisions drawn from a common model.

The independent personal services provision is going to be difficult for both parties to administer. The key terms—"the performance of personal services in an independent capacity" and "fixed base"—are not specially defined in the treaty and are therefore thrown back on the domestic law of each of the treaty partners by the terms of Article 2(2). United States domestic tax law has produced one important ruling on the subject.[180] It has also produced a major decision declaring to be a permanent establishment[181] what must obviously be a fixed base under this treaty.

The joint committee report makes a half-hearted attempt to define the sort of services the provision deals with: "(i.e., services performed as an independent contractor, not as employee)". The attempt of the technical explanation is more adroit by far:

> "Personal services performed in an independent capacity, or independent personal services, are services performed by an individual for his own account where he receives the income and bears the losses arising from such services. If an individual is an independent contractor, he is considered as rendering independent personal services. Generally, services rendered by physicians, lawyers, engineers, architects, dentists, and accountants performing personal services as sole proprietors or partners are independent personal

(177) Art. 18(2) (a) and (c)("...183 days or more...).
(178) Japan-United States, Art. 17(2) (a) and (b) ("...aggregating more than 183 days...").
(179) Korea-Belgium, Art. 14(2) (a) ("...not exceeding 183 days...").
(180) Rev. Rul. 75-131, 1975-1 C.B. 389.
(181) *Georges Simenon*, 44 T.C. 820 (1965) (French treaty).

services."[182]

Why the author of the technical explanation confined his examples to learned professionals is unclear. The rule must be understood to cover self-employed individuals at all levels of the economy. One could wish that so much effort had been expended in an attempt to delimit the "fixed-base" concept.[183]

Overriding all of these considerations, however, is a limitation that does not appear in the Japanese treaty and makes the usefulness of the provision in this treaty virtually nil. The individual who derives income from independent personal services will be taxable in the event that "such income exceeds 3,000 United States dollars or its equivalent in Korean won in a taxable year..."[184] As a practical matter, this reduces the time-period from 182 days to a precious few. Indeed, the self-employed individual in the million-dollar-a-year income class would be well-advised were he to enter on business that he ought not remain in the other nation overnight![185]

c. **Dependent Personal Services.**—The vast majority of individuals fall outside of the preceding category and are taxed in respect of their "dependent personal services." Such services are exempt if rendered in the host country for "less than 183 days in the taxable year" by an employee of a resident of the treaty partner if the remuneration for the services are not borne by the resident's permanent establishment in the host country.[186] A new provision limits them very sharply. The new provision is a requirement that the income during the tax-free period not exceed three thousand United States dollars or its equivalent in Korean won.[187] A short exercise in long division reveals that there are few corporate executives in the world who would be able to

(182) Tech. Ex. 467.
(183) See Huston, "Fixed Base" in Tax Treaties, 5 *Int'l Tan J.* 35(1978).
(184) Art. 18(2) (b).
(185) A fair reading of the treaty seems to permit the treaty trader to take out $3,000 tax free, if and only if his sojourns do not aggregate 183 days in the host country, if and only if he earned no more than that amount as compensation for personal services, and if and to the extent that the income is not attributable to a fixed base maintained in the host country.
(186) Art. 19(2) (a),(b) and (c).
(187) Art. 19(2) (d).

spend even one tax-free working day under such provisions.

Not all employees are subject to these rules. Income tax treaties routinely contain special provisions for special categories of persons. They usually have something to say about teachers, professors, researchers, students, trainees, air crews, ships, companies, corporate directors, performing artists, athletes, and retired persons. These provisions are so common that the absence of any of them from a particular treaty is worthy of note.

(1) **Teachers and Researchers.**—Although OECD treaties omit such language, both American[188] and Korean[189] treaties routinely include provisions exempting professors, teachers, and other persons engaged in academic research. The provision in this treaty allows the two-year sojourn in the host country free of income tax.[190]

By comparison with 182 days and 3,000 U.S. dollars, two years' exemption of unlimited amounts seems quite generous. It also introduces technical issues. While a foreign corporation remains a foreign corporation literally forever, an individual can pass from nonresident to resident status quite easily. A Korean professor teaching for two years at an American university looks very much like a resident of the United States to members of the Internal Revenue Service. Hence, the draftsman is careful to refer to the visitor as a resident of the treaty partner at the time of his invitation and travel. While one could wish that the more explicit provision of the Japanese convention[191] had not been supplanted, this form probably does the job adequately in all but a few cases.

One of those few cases involves the student or trainee who is moved from one program in the host university to another. The Japanese treaty makes it plain that a student may become a professor and remain protected by the exemption.[192] Under the Korean treaty, home leave and a re-establishment

(188) E.g., Japan-United States, Art. 19.
(189) E.g., Korea-Australia, Art. 20.
(190) Art. 20.
(191) Japan-United States, Art. 19(1) ("An individual.../w/ho is a resident of a Contracting State at the beginning of his visit to the other Contracting State...")
(192) See) See Japan-United States, Art. 19(1) (b).

of residence is indicated.

Another involves the professor who stays on for a third year. It *is* clear that the first two years' income is exempt—is it not?[193]

(2) **Students and Trainees.**—The five-year exemption in favor of students, trainees, and researchers, comprising article 21 of this treaty, is virtually an exact copy of the counterpart provision in the United States-Japan convention[194] with Korean won replacing Japanese yen. The exemption runs to remittances from abroad, fellowship grants and $2,000 worth of income from part-time work.[195] The article contains a second exemption for employees of residents of the treaty who come to the host country to acquire experience or to study at a university. These trainees and students are entitled to receive $5,000 tax-free dollars (or its equivalent) from their employers, respectively.[196]

A third category under the provision extends a $10,000 exemption for compensation of "a participant in a program sponsored by the Government of that other Contracting State"[197] and appears to run to military trainees. Neither the joint committee report[198] nor the technical explanation[199] do more than simply repeat the treaty provision, quickly turning to the rules allowing an individual to qualify for whichever of the provisions are most favorable to him, so long as he does not combine the maximum limits of these provisions. In another typical offhand remark, the outer limits of the exemption are drawn. One assumes that becoming a resident of the host country does not result in loss of the treaty exemption. The technical explanation of acquiring immigrant status in the host country *does.*[200]

(3) **Aircrews and Ships' Companies.**—The people who operate ships and aircraft

(193) It is in the United States. See Rev. Rul. 69-236, 1969-1 C.B. 193.
(194) Japan-United States, Art. 21.
(195) Art. 20(1).
(196) Art. 20(2).
(197) Art. 20(3).
(198) Joint Committee Report 454.
(199) Tech. Ex. 468.
(200) Ibid.

in international commerce are difficult to domesticate for tax purpose is under the ordinary rules. Most treaties deal with these people specially.[201] Article 19(3) of this treaty effectively gives to the nation of residence of the ship or airaft operator the exclusive right to tax the compensation for personal services of regular members of their crews.

The rule occasionally produces some odd results. Its counterpart in the Japan convention[202] allowed Japan to tax the salary of an aircrew member of a Japanese flag carrier in respect of services rendered by that member within the State of Alaska, and required the United States to allow that member a foreign tax credit against his United States tax for Japanese taxes thus paid.[203] The same result should be available under this convention.

(4) **Corporate Directors.**—The United States-Japan covention requires that a director's fee derived by an individual residing in a treaty-partner state, in his coapacity as a member of the board of a corporation of the host country, may be taxed by the host country if it is treated as a distribution of profits by the host country, and cannot be taken as a deduction by a corporation of that cuntry.[204] This is an extremely common provision, which appears in the OECD model and draft conventions and in numbers of convention drawn upon them worldwide. It does not have much significance on the American side, because a director's fee is deductible and is not typically treated as a distribution of profits. At any rate, its absence from this treaty is noted.[205]

(5) **Artistes and Athletes,**—Public entertainers of all sorts draw enormous amounts of money for their efforts in a number of segments of contemporary

(201) Not necessarily consistently. Some treaties award taxing jurisdiction to the state of residence of the crew member. See, e.g., Korea-France, Art. 15(3).
(202) Japan-United States, Art. 18(4).
(203) Rev. Rul. 79-28, 1979-1 C.B. 457.
(204) Japan-United States, Art. 18(5).
(205) This is the only Korean income tax convention from which a provision dealing with directors' fees has been omitted. See Korea-Australia, Art. 16; Korea-Belgium, Art. 15; Korea-Canada, Art. 15; Korea-Denmark, Art, Art. 15; Korea-Finland, Art. 16; Korea-France, Art. 16; Korea-German Federal Republic, Art. 15; Korea-Japan, Art. 12(2)(c); Korea-Malaysia, Art. 16; Korea-Netherlands, Art. 17; Korea-Singapore, Ari. 15; Korea-Sweden, Art. 16; Korea-Switzerland, Art. 15; Korea-Thailand, Art. 15(3); Korea-United Kingdom, Art. 15.

industrialized society. The typical fixed-base and permanent-establishment provisions, with or without commercial traveler exceptions, were invitations in the past for itinerant entertainers to move large amounts of money, tax-free, from the country of performance into the country of residence of the performer. Special, stringent provisions appear in many treaties to discourage the practice.[206] The absence of an artistes-and-athletes provision in the Korea-United States treaty will raise an eyebrow for only so long as it takes to realize that the kind of provisions applicable to performers, for example, the United States treaty with Japan,[207] apply to all foreign individuals under the treaty with Korea.

One must add that the possibility of avoiding these provisions may exist, by reason of the failure of these treaty partners to adopt the Japanese entertainer-corporation language,[208] with the result that only the salary agreed on by the entertainer and his corporation are taxable to him in respect of his performance in the host country, the spread between that amount and the price of the performance agreed upon by his corporation being industrial profits" in the nature of furnished personal services.

(6) **Annuitants,**—Individuals receive periodic payments from non-governmental sources for a variety of reasons. Article 23 attempts to sort these out. First of all, all forms of remuneration in respect of prior employment, including pensions, disability payments, death benefits, and all of the rest, are treated as taxable in the nation of residence of the recipient.[209] The can plainly make current compensation in respect of given personal services taxable by one of the treaty partners, while deferred compensation in respect of the same services is taxable by the other. Indeed, to the overseas employee does not become a permanent expatriate, it will be the rule.

Nevertheless, it is probably a sensible rule. The group of recipients is small.

(206) E.g., Korea-United Kingdom, Art. 16.
(207) Japan-United States, Art. 17(3).
(208) Japan-United States Arts. 8(5)(b), 18(3).
(209) Art. 23(1).

Most are entitled to the benefit of tax provisions favoring the aged.[210] Some payments will necessarily be received by persons who did not earn them. (This class is comprised first of all of survivor annuitants and recipients of pension-plan death benefits.[211]

Ordinary commercial annuities, however acquired, are taxable only by their state of residence of the annuitant.[212] An annuity purchased by an American son to pay his Koreanfather for life, and then his American aunt for her life, would appear to shift permissible taxing jurisdictions at the death of the father.

Finally, the treaty provides a rule for alimony. It, too, is taxable by the state of its recipient.[213]

## 9. PAYMENTS BY GOVERNMENTS.

Payments made by governments are subjected to some variation in tax treatment. The prime tendency in the area is for each government to refrain from taxing payments made by its treaty partners. Tax conventions usually deal with these items under three headings. This treaty is typical.

(a) **Diplomatic and Consular Offices.**—From the standpoint of the integrity of the total document, divisions such as article 26 of this treaty come off rather badly. It simply says that nothing in the treaty is to affect the fiscal priveleges of diplomatic and consular officials under the general rules of international law or the provisions of special agreements. The people who supposedly negotiate these conventions reveal quite freely their plans and agreements with respect to their compatriots; their own tax arrangements must be found elsewhere.

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(210) E.g., I.R.C. §151(c)(1) and (2) (additional personal exemption for taxpayers and spouses who have attained the age of 65).

(211) See I.R.C. §401(a)(11) (requirement of survivor annuity option for qualification of pension, etc., plan).

(212) Art. 23(2), (4).

(213) Art. 23(2), (5). Failure to deal with thit issue directly in earlier treaties has created considerable inconvenience. See, e.g., A. Uno Lamm, T.C.M. (P-H) 75,095, 34 T.C.M. (CCH) 473 (1975); A. Uno Lamm, T.C.M. (P-H) 77,336, 36 T.C.M. (CCH) 1345 (1977). (United States treaties with Sweden and the United Kingdom).

"Elsewhere" is, of course, the Vienna convention[214] and the consular agreement.[215]

(b) **Government Employees.**—Current and deferred compensation paid by a government to one of its own citizens out of public funds and in the discharge of governmental functions are declared by the treaty to be exempt from taxation by the treaty partner.[216] In a sense, this provision doubles the protection for diplomatic officials and those of the consular corps who are nationals of the country they represent. It may double the protection afforded by status-of-forces agreements.[217]

Just where the edges of this coverage lie is uncertain. Are the state governments to be regarded as instrumentalities of the United States? The joint committee report answers in the negative: "The exemption only applies to compensation for services performed for the national governments of the United States or Korea.[218] The technical explanation ignores the issue. If a state is not an instrumentality, is the post office? Amtrak? Conrail? Comsat? Particularly in the transportation and communications areas, the "governmental functions" requirements may be difficult to apply.

(c) **Public Pensioners.**—In a few treaties that are still in force,[219] treaty partners find themselves in the wretched posture of taxing social security payments received by their aged residents from their treaty partners. This convention avoids that mistake. It lays down the flat rule, applicable in all cases, that social security payments and other public pensions paid by one state to a resident of the other (and specifically when paid by Korea to a

(214) "A diplomatic agent shall be exempt from all dues and taxes, personal or real, national, regional or municipal, except. ..." Vienna Convention on Diplomatic Relations, Apr. 18, 1961, Art. 34. 500 U.N.T.S. 96, 114.

(215) Consular Convention, Jan. 8, 1963, Korea-United States, Art. 12(3), T.I.A.S. 5469, 14 U.S.T. 1638, 1646.

(216) Art. 22.

(217) Status of Forces, July 9, 1966, Korea-United States, Art. XIV(2). T.I.A.S. 6127, 17 U.S.T. 1677, 1687.

(218) Joint Committee Report 454.

(219) See Treas. Reg. §518.6 (New Zealand-United States treaty), Rev. Rul. 76-121, 1976-1 C.B. 24 (former United States-United Kingdom treaty).

citizen of the United States) are taxable only in the payer country. The provision occupies a exception to the "saving clause."[220] It does not apply to the deferred compensation of government officials.[221] While it does apply to railroad retirement benefits,[222] the language used[223] seems to rule out any benefits received from the states, although neither the joint committee report nor the technical explanation considers the issue.

## 10. ADMINISTERING THE TREATY

**a. The Nature of the Task.**—There is a tendency to terminate discussions of new treaties just prior to arriving at the administrative provisions. Such provisions are usually drafted in vague and general terms. They rarely form the subjects of rulings or decisions. They have, until fairly recently, evoked little comment. Yet they merit more than cursory examination, because they contain primary means of avoiding fiscal evasion and at least a secondary means for dealing with issues of double taxation that have tumbled through the substantive provisions and have emerged unresolved.

**b. Exchange of Information.**—Crucial to the enforcement efforts of the nations who enter into tax treaties is free exchange of informatioin with treaty partners. Exchange-of-information articles have been drafted into income tax treaties for a long while. They seem to have been largely ineffective for roughly the same period.[224] In recent years, some nations (and notably the United States of America) have become increasingly hard-nosed regarding the process of obtaining information deemed necessary to control income tax evasion at the international level. Nevertheless, it is clear that the bulk of its information exchange occurs with its principal trading partners, Canada and

(220) The exception appears at Art. 4(5)(a).
(221) Art. 24 (second sentence).
(222) Tech. Ex. 469.
(223) "Social security payments and other public pensions paid by one of the Contracting States...." Art. 24 (first sentence).
(224) See Seeman, Exchange of Information under International Tax Conventions. Int'l Law. 333, 344 (197).

Japan.[225]

Exchange-of-information procedures operate at three levels.[226] The first of these requires each country to exchange information concerning changes in its own laws, statutes, and regulations. This treaty devotes two paragraphs to the subject, the first concerning tax law amendments, and the other to "any material concerning the application of the Convention."[227]

A second provision requires routine exchange of "such information as is necessary for carrying the provisions of this Convention..."[228] This typically involves reporting by one government to the other of payments of income made by domestic payers to persons having home addresses in the territory of the treaty partner.[229]

Requests at the third level are made on an individualized basis. Here, each nation agrees to provide information respecting its own residents, including depositions of the witnesses and copies of unedited original documents.[230]

The difference between the text of this treaty and its Japanese antecedent[231] is significant. Notable in particular is adoption of the specific-request procedure out of the United States model treaty[232] a year before the publication of the latter. It is an indication, at least, that both parties to the treaty are willing to exchange information pursuant to its provisions. From the standpoint of securing taxpayer compliance, this is a hopeful sign.

**c. Assistance in Collection.**—Unfortunately for international tax enforcement, the teeth in this provision are entirely in its title. Examination of the text of the provision indicates that mutual assistance in the collection of taxes is to

(225) See Kingson, The Coherence of International Taxation, 81 Bolum. L. Rev. 1152, (1981). See Egger, Statement before Commerce, Consumer and Monetary Affairs Subcommittee of House of Representatives Committee on Government Opeerations, June 10, 1982, reprinted at P-H Tax Treaties para. 110,051 (1982).

(226) See, Shockey, Exchange of Information Provisions in the United States Tax Treaties, 78-8 Tax Mgmt. Int'l J. 8 (1978).

(227) Art. 28(6) and (7).

(228) Art. 28(1).

(229) See Treas. Reg. §1.1461-2(d).

(230) Art. 28(4).

(231) Japan-United States, Art. 26.

(232) United States Treasury Model, Art. 26(3) (May 17, 1977).

occur only when necessary to prevent persons not entitled to treaty benefits from enjoying them.[233]

It is difficult to determine what effect, if any, the inclusion of this provision in United States treaties over the years may have had. Its absence from the OECD draft and model conventions, taken with current United States attempts to deny benefits through the use of its new "Article 16",[234] is some indication that the provision is largely decorative.

It may well be that this language represents an attempt to condition taxing officials to be thinking in terms of international tax collection on a routine basis. If movement has thus been produced, its pace is glacial, at best.

**d. Mutual Agreement Procedure.**—Article 2 of the treaty designates the United States Secretary of the Treasury or his delegate and the Korean Minister of Finance or his delegate as the competent authorities, respectively,[235] of the parties to this convention. Article 27 assigns to the competent authorities their principal tasks.[236]

In order to carry out their tasks, they are authorized to communicate directly or to meet and discuss their mutual problems outside of normal diplomatic channels.[237] Far more important, they are authorized to arrive at settlements impossible to reach at lower governmental levels where decisions, regulations, and rulings unduly limit administrative discretion.[238]

The lesser of the two sorts of duties that are imposed by the treaty on the competent authorities is the duty "to resolve by mutual agreement any difficulties or doubts arising as to the application of this Convention." The com-

(233) Art. 30(1).

(234) Article 17 in this treaty.

(235) Art. 2(f).

(236) References to competent authority appear in a number of treaty articles. A second reference in Article 2 empowers the competent authorities to establish common meaanings for treaty terms. Art. 2(2) (last sentence). Article 3(2)(e) turns to the competent authorities when the treaty tests fail to fix the treaty residence of a dual resident. Article 6(9) authorzes establishing additional source rules for purposes of the teaty. Finally as earlier noted, it is the competent authorities who exchange information under Article 28.

(237) Art. 27(3).

(238) See Koch, Mutual Agreement—Procedure and Practice: General Report, 66a Cahiers de droit fiscal international (Studies on International Fiscal Law) 249, 266 (1981).

petent authorities are authorized to agree with respect to all sorts of items—attribution to a permanent establishment, allocation of income deduction and credit items, source determinations, accounting methods, and the meaning of terms. It does not give them the power to promulgate regulations; some treaties do.[239] As a practical matter, it seems of minimal importance. There appears a general reticence toward exercising any of the powers herein mentioned.[240]

This reticence is unfortunate. Tax treaties, like other dynamic documents, change in meaning to accommodate the realities of practice. Declining any meaningful commentary beyond a joint committee report, a technical explanation, and a rare administrative ruling, the taxing authorities may be creating enforcement difficulties by denying planning information to those who must shape international transactions.

More important by far, and the single most useful administrative provision in contemporary tax treaties, appears here as article 27(1). It confers upon a taxpayer who believes that either or both of the treaty partners have acted in such a way as to "result for him in taxation not in accordance with Convention" to call upon the competent authority of the nation of his residence to deal with the matter. The resident-state competent authority is to review his plaint, and if he finds it meritorious, to negotiate a settlement with his counterpart competent authority. The result of the negotiations may be the imposition of tax, or the refund or credit of taxes. Refunds or credits are not barred by domestic-law statutes of limitations.

Mutual agreement procedure deals with the most difficult issues of treaty taxation—the majority appearing to arise in the complex transfer-pricing area. Negotiating them through to satisfactory solution requires a high degree of ability, an acute understanding of taxpayer problems and techniques, and con-

(239) See, e.g., Austria-United States XIX(1).

(240) See Avery-Jones, Berg, Depret, Ellis, Fontaneau, Lonz, Miyatake, Roberts, Sandels, Strobl & Ward, The Legal Nature of Mutual Agreement Procedure (Part 1—), 1979 Brit. Tax Rev. 333; (Part 2—), 1980 Brit. Tax Rev. 13, 20.

siderable patience.

The competent authority structure of the United States may provide an adequate model for counterpart administrative structures elsewhere. In contrast to that of many nations, whose competent-authority procedures are shrouded in secrecy, the American administrative structure is published, as are the powers of the officers involved; and the procedures by which the taxpayer gains access and plays a part in the process have been set out in some detail.(241)

## IN CONCLUSION.

The Korea-United States tax treaty seems typical of the individual links that together comprise an international network of tax conventions. Each is unique, differing from all of the others in one or several respects. Only a few differ radically to any degree. This treaty is not one of those few.

Given its administrative provisions and the mutual resolve to succeed in the complex task of creating and improving operating procedures under them, the convention holds great promise for the future fiscal relations of the treaty partners.

(241) See Cole, Huston & Weiss, op. cit. supra note 237 at 266 (USA National Report).