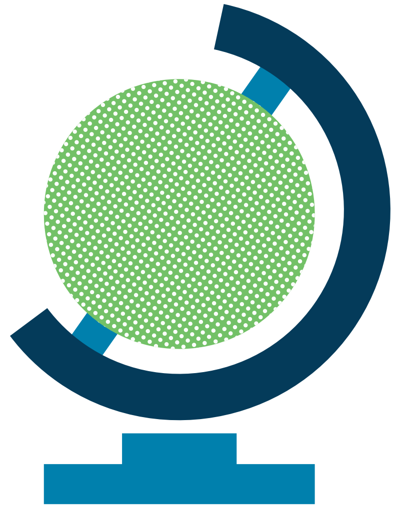
INTERNATIONAL TIDBIT:

Conventionally Speaking, Tax and Other Benefits Abound



International Tidbits have highlighted, on several occasions, the importance of double taxation treaties or "conventions" in planning for the income tax implications of cross-border investments and operations. These useful tools are agreements between sovereign states as to how they will address situations in which a resident (including individuals and business entities) of one state incurs income tax in the other state while still being taxed in the country of residence. Although having all the hallmarks of a contract in the sense of a binding agreement between two parties, because these parties are sovereign nations, these contracts are typically referred to as "treaties" or "conventions for the avoidance of double taxation."

DOUBLE TAXATION TREATIES (INCOME TAX TREATIES)

Benefits of double taxation treaties include protecting companies from having a taxable presence in a foreign country as a result of undertaking certain business activities there, preventing employees from being subject to personal income tax while on short-term assignments in another country, and offering exemptions or credits as a means of alleviating the burden of paying income tax in two countries on one stream of income.

Currently, the U.S. has treaties in place covering income tax with 69 countries, as listed on the IRS website. What these conventions do not cover are state income and franchise taxes, social taxes such as social security and national health insurance contributions, transaction taxes such as sales or value added tax, capital duties (except in a few instances), and taxes on transfers of property by gift or inheritance.

Today's Tidbit focuses on treaties other than income tax conventions and highlights how these other treaties may also be useful when people and their businesses cross borders and invest in other countries.

SOCIAL SECURITY TOTALIZATION AGREEMENTS

While not titled "treaties," these agreements are between governments and provide relief for individuals with respect to social security-type taxes. The agreements eliminate duplicate social security coverage and taxation. An employee transferred to a totalization country can remain in his home country social security system if two conditions are met. First, the assignment must be expected to last for no more than five years. Second, the individual must remain an employee of the sending employer. In many countries of the world, the amount of social taxes required to be withheld from an employee's compensation, as well as the employer's portion of these taxes, can be significantly higher than the U.S., even topping 50%. The U.S. currently has 24 Totalization agreements in place, chiefly with major industrialized nations.

Additionally, the totalization agreement eliminates loss of social security benefits when an individual has had significant work periods in both countries. Under a totalization agreement, the employee may qualify for partial U.S. and partial foreign social security benefits based on combined work credits from both countries.

ESTATE AND GIFT TAX TREATIES

U.S. treaties covering estate or inheritance taxes and gift taxes (although not always both types of taxes) are less numerous and involve only 16 countries. The older versions of these treaties tended to bestow the right to tax property to the country in which a decedent or donor's property, whether real or personal, was located. More recent treaties look to where the decedent or donor is domiciled (as opposed to resident) and grants the primary right of taxation to the country of domicile with a credit for taxes paid in the other country. These treaties may be especially helpful in avoiding double taxation in cases where a foreign country exacts an inheritance tax on heirs who receive property from a decedent while the U.S. taxes the decedent's estate. The U.S. currently has 16 of these treaties.

FRIENDSHIP, COMMERCE AND NAVIGATION TREATIES

Sometimes a first step toward an eventual double taxation treaty covering income taxes is a treaty of friendship, commerce and navigation can be important in establishing a basis for commercial relationships based on not discriminating in favor of residents of a signatory country.

SHIPPING AND AIRCRAFT AGREEMENTS

Another type of treaty that may be a precursor to a double taxation treaty is an agreement pertaining to shipping and aircraft. The coverage of these agreements is narrow and could exempt from tax any income with respect to the operation of ships or aircraft in international operation. For example, the crew of a scheduled commercial aircraft flying from a foreign airport to the U.S. will not be subject to tax on income attributable to the services they perform while physically present in the U.S. However, this would not apply to a vessel, such as a barge with a nonresident crew, which is chartered for oil exploration services at a location in territorial waters in the U.S. and is not engaged in international transportation of passengers or cargo. The U.S. currently has 43 such agreements.

FREE TRADE AGREEMENTS

The U.S. has entered into a number of multilateral and bilateral free trade agreements (e.g., NAFTA). A chief objective of these agreements is to reduce tariffs or ad valorem taxes on the importation of goods whose origin is in a signatory country. These agreements do not provide relief from value added taxes that may also apply when goods are imported, and which are also based on the declared value of the goods. Free trade agreements do not provide relief with respect to income taxes, although the U.S. has double taxation treaties with a number of the countries covered by free trade agreements.

An important aspect of free trade agreements can be the provisions covering expropriation of property and offering arbitration as a means of dispute resolution and determination of compensation. The U.S. has 12 free trade agreements in force involving 18 countries.

BILATERAL INVESTMENT TREATIES

Without providing for the reduction of taxes in the form of import duties as in free trade agreements, the U.S. has entered into bilateral investment treaties addressing other matters that may also be covered in bilateral trade agreements. They may address issues such as the free flow of investment capital and favorable treatment of investments on a par with what is enjoyed by residents. The requirement to handle disputes through arbitration can make these treaties particularly attractive for cross-border investment. The U.S. has 51 bilateral investment treaties.

EXCHANGE OF INFORMATION AGREEMENTS

In the last few years and in the midst of heightened publicity about use of foreign bank accounts and investments to evade U.S. and other countries' income taxes, a number of countries and low-tax jurisdictions, including those long viewed as tax havens, have entered into exchange of information agreements with the U.S. These permit the U.S. to request tax-related information from signatories about U.S. taxpayers and permit the U.S. to provide information in response to a request from a signatory about its taxpayers. These same provisions may be embodied as part of a comprehensive double taxation agreement. The U.S. has 27 agreements in place for the exchange of tax information.

While the greatest opportunities for reducing taxes still lie with the traditional conventions for the avoidance of double taxation, other types of international agreements may be helpful in reducing other taxes and tariffs or obtaining relief in the case of expropriation of property.
