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U.S. Department of the Treasury

PRESS RELEASES

TREASURY DEPARTMENT
TECHNICAL EXPLANATION OF THE CONVENTION
BETWEEN THE UNITED STATES OF AMERICA
AND THE KINGDOM OF THE NETHERLANDS
FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION
OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME
SIGNED AT WASHINGTON ON DECEMBER 18, 1992
AND
PROTOCOL SIGNED AT WASHINGTON ON OCTOBER 13, 1993

INTRODUCTION

This document is a technical explanation of the Convention between the United States and the Netherlands signed on December 18, 1992 ("the Convention") and the Protocol amending the Convention signed on October 13, 1993 ("the Protocol"). References are made to the Convention between the United States and the Netherlands with Respect to Taxes on Income and Certain other Taxes, signed on 29 April, 1948, as amended by the Supplementary Convention signed on December 30, 1965 ("the prior Convention"). The Convention replaces the prior Convention. Negotiations took as their starting point the U.S. Treasury Department's draft Model Income Tax Convention, published on June 16, 1981 ("the U.S. Model"), the Model Double Taxation Convention on Income and Capital, published by the OECD in 1977 ("the 1977 OECD Model"), and other Conventions of both States. References in this Explanation to the "OECD Model" refer to the Model Income Tax Convention on Income and on Capital, published by the OECD in 1992.

The Technical Explanation is an official guide to the Convention and Protocol. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention and Protocol.

The Convention was accompanied by an exchange of notes and a detailed Memorandum of Understanding indicating the views of the negotiators and of the States with respect to a number of the provisions of the Convention. The Protocol also was accompanied by an exchange of notes and Agreed Minutes indicating the views of the negotiators and of the States with respect to a number of the provisions of the Convention and Protocol. In the discussions of each Article in this explanation, the relevant portions of these documents are discussed.

Article 1 - GENERAL SCOPE

Article 1 provides that the Convention is applicable to residents of the United States or the Netherlands except where the terms of the Convention provide otherwise. The Convention, at the

request of the Netherlands, departs from the convention adopted in the U.S. and OECD Models, and employs the term "State" instead of the term "Contracting State" to refer to the United States or to the Netherlands. In this explanation, the terms are used interchangeably.

Under Article 4 (Resident) a person is treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of his domicile, residence or other similar criteria, subject to certain limitations described in Article 4. If, however, a person is, under those criteria, a resident of both Contracting States, a single State of residence (or no State of residence) is assigned under Article 4. This definition governs for all provisions of the Convention. Certain provisions are applicable to persons who may not be residents of either Contracting State. For example, Article 20 (Government Service) may apply to a citizen of a Contracting State who is resident in neither. Paragraph 1 of Article 28 (Non-Discrimination) applies to nationals of the Contracting States, irrespective of their residence. Under Article 30 (Exchange of Information and Administrative Assistance), information may be exchanged with respect to residents of third States.

Paragraph 2 of Article 1, like the comparable provision of the U.S. Model, describes the relationship between the rules of the Convention, on the one hand, and the laws of the Contracting States and other agreements between the Contracting States, on the other. This paragraph makes explicit, subject to one exception in the case of the Netherlands as described below, the generally accepted principle that no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other allowance accorded by the tax laws of the Contracting States. For example, if a deduction would be allowed under the Internal Revenue Code (the "Code") in computing the taxable income of a resident of the Netherlands, the deduction will be available to that person in computing income under the Convention. In no event may the Convention increase the tax burden on a resident of a Contracting State beyond that permitted under the State's internal law. Thus, a right to tax given by the Convention cannot be exercised by the United States unless that right also exists under the Code.

A taxpayer may generally rely on more favorable treatment afforded under the Code. A taxpayer may not, however, pick and choose among Code and Convention provisions in an inconsistent manner in order to minimize tax. For example, assume a resident of the Netherlands has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that do not meet the permanent establishment threshold tests of the Convention. One is profitable and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable, and both the profit and the loss of the other two businesses are ignored. Under the Code, all three would

be taxable. The loss would be offset against the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to offset the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17 C.B. 1984-1, 10.) If the taxpayer invokes the Code to subject all three ventures to U.S. tax, he would not be precluded from invoking the Convention with respect to, for example, any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

Similarly, nothing in the Convention can be used to deny any benefit granted by any other agreement between the United States and the Netherlands. For example, if certain protections, not found in the Convention, are afforded under a Consular Convention or under a Treaty of Friendship, Commerce and Navigation, those protections will be available to residents of the Contracting States regardless of any provisions to the contrary (or silence) in the Convention.

As noted above, there is an exception to the general rule that the Convention cannot restrict or deny any more favorable statutory benefit. This rule does not apply, as regards the Netherlands, with respect to Article 25 (Methods of Elimination of Double Taxation). Treaty relief from double taxation in the Netherlands differs from the statutory relief. Even if, in a particular circumstance, the statutory relief would provide a greater benefit, the taxpayer is precluded, under the Convention, from invoking the statutory rule.

The "saving clause" provisions of paragraphs 3 and 4 of Article 1 of the U.S. Model, preserving certain statutory taxing rights of the Contracting States, are found in Paragraphs 1 and 2 of Article 24 (Basis of Taxation) of the Convention.

Article 2 - TAXES COVERED

This Article identifies the U.S. and Netherlands taxes to which the Convention applies. These are referred to in the Convention as "United States tax" and "Netherlands tax," respectively.

Subparagraph 1(a) specifies the existing Netherlands taxes to which the Convention applies. These are the inkomstenbelasting (income tax), the loonbelasting (wages tax), the vennootschapsbelasting (company tax) and the dividendbelasting (dividend tax). The company tax includes the "profit share," which is the government share in the net profits arising from the exploitation of natural resources levied pursuant to the Mining Act of 1810 (Mijnwet 1810) with respect to concessions issued from 1967, or

pursuant to the Netherlands Continental Shelf Mining Act of 1965 (Mijnwet Continentaal Plat 1965). Special rules are provided in paragraph 5 of Article 25 (Methods of Elimination of Double Taxation) for the calculation under the Convention of the U.S. foreign tax credit for the profit share.

The covered taxes of the United States are specified in subparagraph 1(b). They are the Federal income taxes imposed by the Code and the excise taxes imposed on insurance premiums paid to foreign insurers (Code section 4371), and with respect to private foundations (Code sections 4940 through 4948). The Convention does not apply to social security taxes (Code sections 1401, 3101 and 3111). U.S. and Netherlands social security taxes are dealt with in the bilateral Social Security Totalization Agreement, which entered into force on November 1, 1990.

The Convention applies to the federal excise tax on insurance premiums only to the extent that the risks covered by such premiums are not reinsured, directly or indirectly, with a person not entitled, under this or any other Convention, to exemption from the tax. Under the Code, the tax applies to a Netherlands company only if it earns premiums that are not attributable to an active trade or business in the United States or are exempt by treaty from U.S. net basis income tax. Providing Convention coverage for the U.S. insurance excise tax effectively exempts from the tax certain premiums received by Netherlands companies from the insurance of U.S. risks, subject to the anti-conduit rule for reinsurance, described above. This result is confirmed in paragraph 7 of Article 7 (Business Profits). Under Article 7 (Business Profits), the United States does not subject the business profits of a Netherlands enterprise to tax (i.e., a covered tax) if the income of the enterprise is not attributable to a permanent establishment that the enterprise has in the United States. In contrast with this Convention, the prior Convention did not cover the insurance excise tax, allowing it to be imposed on premiums paid to Netherlands insurers if such premiums were not attributable to a permanent establishment of the insurer in the United States. As Treasury has discussed in prior consultations with the staffs of the Foreign Relations Committee and the tax-writing committees of Congress, Treasury's review of the Netherlands' taxation of the income of Dutch insurance companies indicated that it results in a burden that is substantial in relation to the U.S. tax on U.S. insurance companies. Treasury accordingly believed that it was appropriate to waive the tax with the Netherlands, as was done in the case of the recent conventions with Germany, Spain, Finland and India.

Unlike the U.S. Model, the Convention applies to the accumulated earnings tax (Code section 531) and the personal holding company tax (Code section 541). Paragraph 6 of Article 10 (Dividends) prohibits the imposition of these taxes on Netherlands companies.

Except with respect to Article 28 (Non-Discrimination), state and local taxes in the United States are not covered by the Convention. Article 28 prohibits discriminatory taxation with respect to all taxes, whether or not they are covered taxes under Article 2, and whether they are imposed by the Contracting States, their political subdivisions or local authorities. In an exchange of notes signed at the time of the signing of the Convention, the United States agreed that, although state and local taxes are not covered under the Convention, if a state or local government seeks to impose an income tax on a Netherlands shipping or airline company in circumstances in which the Convention prohibits the imposition of a Federal income tax, the U.S. Government will seek to persuade that state or local government to refrain from imposing the tax.

Under paragraph 2, the Convention will apply to any taxes that are identical, or substantially similar, to those enumerated in paragraph 1, and that are imposed in addition to, or in place of, the existing taxes after December 18, 1992 (the date of signature of the Convention). The paragraph also provides that the U.S. and Netherlands competent authorities will notify each other of significant changes in their taxation laws. This requirement refers to changes that are of significance to the operation of the Convention.

Article 3 - GENERAL DEFINITIONS

Paragraph 1 of Article 3 defines a number of basic terms used in the Convention. Terms that are not defined in the Convention are dealt with in paragraph 2. Certain others are defined in other articles of the Convention. For example, the term "resident of one of the States" is defined in Article 4 (Resident). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). The terms "dividends," "interest" and "royalties" are defined in Articles 10, 12 and 13, respectively, which deal with the taxation of those classes of income.

The term "State" is defined in subparagraph 1(a) to mean the United States or the Netherlands, depending on the context in which the term is used. The term "States" is defined as the United States and the Netherlands.

The terms "the Netherlands" and "United States" are defined in subparagraphs 1(b) and (c), respectively. The term "the Netherlands" means that part of the Kingdom of the Netherlands that is situated in Europe (i.e., excluding the Netherlands Antilles and Aruba). The term includes the Dutch continental shelf (with respect to the exploration or exploitation of natural resources).

The term "United States" is defined to mean the United States of America, not including Puerto Rico, the Virgin Islands, Guam or

any other U.S. possession or territory. When used geographically, the term means the 50 states and the District of Columbia. The U.S. continental shelf (with respect to the exploration or exploitation of natural resources) is also specifically included within the definition of the United States.

Subparagraph 1(d) defines the term "person" to include an individual, an estate, a trust, a company and any other body of persons. The term "company" is defined in subparagraph 1(e) as a body corporate or an entity treated as a body corporate for tax purposes. Since the term "body corporate" is not defined in the Convention, in accordance with paragraph 2 of this Article, it has the meaning that it has under the law of the Contracting State whose tax is being applied. Thus, for U.S. tax purposes, the principles of Code section 7701 will be applied to determine whether an entity is a body corporate. The definition of "person" in the U.S. Model includes partnerships. The Convention, however, follows the OECD Model by not making specific reference to partnerships. It was agreed during the negotiations, however, that the term "person" would be understood to include partnerships.

The terms "enterprise of one of the States" and "enterprise of the other State" are defined in subparagraph 1(f) as an enterprise carried on by a resident of one of the States and an enterprise carried on by a resident of the other State, respectively. The term "enterprise" is not defined in the Convention.

The term "nationals," as it relates to both the United States and the Netherlands, is defined in subparagraphs 1(g)(i) and (ii). A national of the United States is (1) a U.S. citizen, and (2) any legal person, partnership or association deriving its status as such from the law in force in the United States. A national of the Netherlands is correspondingly defined as (1) an individual possessing the nationality of the Netherlands, and (2) any legal person, partnership or association deriving its status as such from the law in force in the Netherlands. This definition is comparable to that found in the OECD Model. A U.S. national is defined in the U.S. Model as a citizen of the United States, and does not include juridical persons. The addition in the Convention of juridical persons to the definition may have significance in relation to paragraph 1 of Article 28 (Non-Discrimination), which provides that nationals of one of the States may not be subject in the other State to any taxes or connected requirements that are other or more burdensome than those applicable to nationals of that other State who are in the same circumstances.

Subparagraph 1(h) defines the term "international traffic." This definition is significant principally in relation to Article 8 (Shipping and Air Transport), but also is relevant to Article 16 (Dependent Personal Services) and Article 27 (Offshore Activities). The term means any transport by a ship or aircraft operated by an enterprise of one of the States, except when the vessel is

operating solely between places within the other State. The exclusion from international traffic of transport solely between places within one of the States means, for example, that carriage of goods or passengers between New York and Chicago by either a U.S. or a Netherlands carrier would not be treated as international traffic. The substantive taxing rules of the Convention relating to the taxation of income from transport, principally Article 8 (Shipping and Air Transport), therefore, would not apply to income from such carriage. If the carrier is a Netherlands resident (if that were possible under U.S. law) the United States would not be required to exempt the income under Article 8. The income would, however, be treated as business profits under Article 7 (Business Profits), and, therefore, would be taxable in the United States only if attributable to a U.S. permanent establishment, and then only on a net basis. The gross basis U.S. tax would never apply under the circumstances described. If, however, goods or passengers are carried from Rotterdam to New York, and some of the goods or passengers are carried only to New York, while the rest are taken to Philadelphia, the entire transport, including the New York to Philadelphia portion, would be international traffic.

Subparagraphs 1(i)(i) and (ii) define the term "competent authority" for the Netherlands and the United States, respectively. The competent authority of the Netherlands is the Minister of Finance or his duly authorized representative. The U.S. competent authority is the Secretary of the Treasury or his delegate. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who has, in turn, redelegated the authority to the Assistant Commissioner (International). With respect to interpretative issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service.

Paragraph 2 establishes a procedure for determining a definition for a term, for purposes of the Convention, that is not otherwise defined in the Convention. The paragraph provides the general rule that any such term will have the meaning that it has under the law of the Contracting State whose tax is being applied. A meaning other than this statutory meaning may be used, however, if the context so requires, or if the competent authorities, pursuant to the authority granted to them in paragraph 3 of Article 29 (Mutual Agreement Procedure), so agree. If, for example, the meaning of a term cannot be readily determined under the law of a Contracting State, or if there is a conflict in meaning under the laws of the two States which creates problems in the application of the Convention, the competent authorities may establish a common meaning in order to prevent double taxation or further any other purpose of the Convention. This common meaning need not conform to the meaning of the term under the laws of either Contracting State.

Article 4 - RESIDENT

This Article sets forth rules for determining whether a person is a resident of the United States or the Netherlands for purposes of the Convention. As noted in the explanation to Article 1 (General Scope), as a general matter only residents of the Contracting States may claim the benefits of the Convention. The definition of resident in the Convention is to be used only for purposes of the Convention. The prior Convention contains no comprehensive definition of a resident.

In general, a person will be considered a resident of a Contracting State if he is subject to tax in that State under its internal law by reason of his residence, domicile, or other similar criterion. A person who, under this rule, is a resident of one State and not of the other will generally (subject to an exception described below) be treated for purposes of the Convention as a resident of the State in which he is resident under internal law. If, however, a person is resident in both Contracting States under their respective taxation laws, the Article proceeds, where possible, to assign a single State of residence to such a person for purposes of the Convention through the use of tie-breaker rules or competent authority agreement.

Paragraph 1 defines the term "resident of one of the States." In general, this definition incorporates the definitions of residence in U.S. and Netherlands law. A resident of a State is a person who, under the laws of that State, is subject to tax there by reason of his domicile, place of management, place of incorporation or any other criterion of a similar nature. Residents of the United States include aliens who are considered U.S. residents under Code section 7701(b). Unlike the U.S. Model, "citizenship" is not included among the explicit criteria of residence in the Convention. However, it is understood to be a "criterion of a similar nature" under paragraph 1. An exception to this general rule for certain individuals is described below.

Paragraph 1 clarifies that certain non-taxable entities, even though not liable to tax in a State, are nevertheless to be treated as residents of a State if so treated under the laws of that State. The entities referred to are exempt pension trusts dealt with in Article 35 (Exempt Pension Trusts), and exempt organizations dealt with in Article 36 (Exempt Organizations). Even in the absence of this explicit reference, such organizations should be considered residents of their State of organization under the general rule because they are subject to the taxation laws of that State. It was deemed useful, however, to include this clarification due to the fact that these entities generally do not incur liability to pay taxes. This list is not exhaustive: additional entities that qualify as residents of a State under the tax laws of that State and that are exempt from tax in that State (e.g., by virtue of being government-owned or operated for public purposes) also may be

considered residents under Article 4 despite the fact that they are not described in Articles 35 or 36. Paragraph I. of the Memorandum of Understanding notes that the Government of a State, as well as its political subdivisions and local authorities, are to be considered as residents of that State.

Subparagraph 1(a) specifies that a person liable to tax in a State only in respect of income from sources within that State will not be treated as a resident of that State for purposes of the Convention. For example, a Dutch consular official stationed in the United States, who may be subject to U.S. tax on his U.S. source investment income, but is not taxable in the United States on his salary and non-U.S. source income, by operation both of Article 20 (Government Service) and Code section 893, would not be considered a resident of the United States for purposes of the Convention. Similarly, a Netherlands enterprise with a permanent establishment in the United States is not, by virtue of that permanent establishment, a resident of the United States. The enterprise is subject to U.S. tax only with respect to its income attributable to the U.S. permanent establishment, not with respect to its world-wide income, as is a U.S. resident.

Subparagraph 1(b) makes clear that an estate or trust will be treated as a resident of a Contracting State for purposes of the Convention only to the extent that the income derived by such person is subject to tax in that State as the income of a resident, either in the hands of the person deriving the income or in the hands of its beneficiaries. Under U.S. law, an estate or trust is often not itself a taxable entity. Thus, for U.S. tax purposes, the question of whether income received by such an entity is received by a resident will be determined by the residence for taxation purposes of the person subject to tax on such income, which may be the grantor, the beneficiaries or the estate or trust itself, depending on the circumstances. This rule regarding the residence of estates or trusts is applied to determine the extent to which that person is entitled to treaty benefits with respect to income that it receives from the other Contracting State. In the U.S. Model, the provision corresponding to subparagraph 1(b) includes partnerships as well as estates and trusts. Subparagraph 1(b) does not refer to partnerships because both the United States and the Netherlands treat partnerships as pure conduits. Thus, by operation of internal law, both States look to the residence of the partners of a partnership for purposes of determining the availability of the benefits of the Convention to the partners, even without an explicit reference to partnerships in the Convention.

As noted above, paragraph 1 contains an exception for certain individuals to the general rule that residence under internal law also determines residence under the Convention. It is not always sufficient for an individual to be a resident under the laws of one of the States (or a citizen of the United States) to be treated as

a resident of that State under the Convention. Such an individual, unless he is also a resident of the other State, will be treated under the Convention as a resident of the State in which he is resident under its law (or of which he is a citizen, in the case of the United States) only if the individual has a closer nexus to that State than to any third State. If the individual's State of residence does not have a tax treaty with the third State in question, he will be treated under the Convention as a resident of his State of residence only if he would be a resident of that State and not of the third State under the tie-breaker tests of subparagraphs (a) and (b) of paragraph 2 of Article 4. If, however, the individual's State of residence does have a tax treaty with the third State, then he must be a resident of his State of residence and not of the third State under the residence rules of that second Convention.

For example, if a U.S. citizen, or a U.S. green card holder, has a permanent home in a third State with which the United States has no income tax convention, the person has no permanent home in the United States, and he is not a resident of the Netherlands under Dutch law, such individual would not be treated as a resident of the United States under the Convention. He therefore would not be entitled to treaty benefits. If that individual has a permanent home in both the United States and the third State, and his center of vital interests is in the third State, or if his center of vital interests cannot be determined and his habitual abode is in the third State, he would not be entitled to benefits under the Convention. Similarly, if the individual is a resident of both the United States and Canada under the internal laws of both countries, but under the tie-breaker rules of the U.S.-Canada income tax treaty he is treated as a resident of Canada, that individual would not be treated as a U.S. resident under the Convention, and would not be entitled to claim benefits thereunder.

If an individual is considered a resident of each State under its laws, the exception described above does not apply, and a single State of residence is determined by application of the tie-breaker rules of paragraph 2. Paragraph 2(a) provides that such an individual will be resident in the State in which the individual has a permanent home. If the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State to which his personal and economic relations are closest, i.e., the location of his "centre of vital interests." Under paragraph 2(b), if he has no centre of vital interests or if he does not have a permanent home available to him in either State, he will be treated as a resident of the Contracting State in which he maintains an habitual abode. Under paragraph 2(c), if he has an habitual abode in both States or in neither of them, he will be treated as a resident of the State of which he is a national. If he is a national of both States or of neither, paragraph 2(d) provides that the competent authorities will attempt by mutual agreement to assign a single State of

residence.

Paragraph 3 addresses dual-residence issues for persons other than individuals or companies that are considered residents of both States under paragraph 1. Under this paragraph, the competent authorities are instructed to determine a single State of residence by mutual agreement, and determine how the Convention is to apply to such persons.

Paragraph 4 addresses corporations that are treated by each State, under its laws, as a resident of that State. A corporation is treated as resident in the United States if it is created or organized under the laws of the United States or a political subdivision. Under Dutch law a corporation is treated as a resident of the Netherlands if it is either established there or managed and controlled there. Dual residence, therefore, can arise if a U.S. corporation is managed and controlled in the Netherlands. Paragraph 4 provides that the competent authorities will try to determine a single State of residence. In doing so, they are instructed to take into account such factors as the place of incorporation and the place of management. In the event that the competent authorities do not agree on a single State of residence, the paragraph provides that the corporation shall not be considered to be a resident of either the United States or the Netherlands for purposes of deriving any benefits of the Convention, except for the benefit of the U.S. foreign tax credit under paragraph 4 of Article 25 (Methods of Elimination of Double Taxation), and the benefits of Articles 28 (Non-discrimination), 29 (Mutual Agreement Procedure) and 37 (Entry Into Force). Thus, a State cannot discriminate against a dual resident corporation, and such a corporation can bring issues to the competent authorities.

Dual resident corporations may be treated as resident for purposes other than that of obtaining benefits under the Convention. For example, if a dual resident corporation pays a dividend to a resident of the Netherlands, the U.S. paying agent would withhold on that dividend at the appropriate treaty rate, since reduced withholding is a benefit enjoyed by the resident of the Netherlands, not by the dual resident. The dual resident corporation that paid the dividend would, for this purpose, be treated as a resident of the United States under the Convention. Since, by its terms, Article 30 (Exchange of Information and Administrative Assistance) is not limited to residents of the Contracting States, information relating to dual resident corporations can be exchanged. To the extent that the Convention is relevant for dual-resident corporations, it must enter into force for such purposes. Therefore, Article 37 (Entry Into Force) also applies for dual-resident corporations.

Paragraph II. of the Memorandum of Understanding clarifies that if a company that is a resident of the Netherlands under paragraph 1 of the Article is treated under U.S. law as a resident

of the United States by application of Code section 269B (i.e., because it and a U.S. corporation are stapled entities), the determination of the residence of the entity will be made under the rules of paragraph 4, which allow the competent authorities to determine a single State of residence for a corporation by mutual agreement. The authority of the Internal Revenue Service under section 269B(b) of the Code to prevent avoidance or evasion of Federal income tax through the use of stapled entities is not affected by such an agreement. Therefore, in accordance with the authority provided by section 269B(b), the Internal Revenue Service may, for example, require that such an entity will be treated as being owned (to the extent of the stapled interest) by the entity to which its stock is stapled.

However, in accordance with Notice 89-94 C.B. 1989-2, 416, any Netherlands corporation that was stapled to a U.S. corporation as of June 30, 1983, and which was entitled to claim benefits under the prior Convention on that date because it was considered a resident of the Netherlands, will continue for U.S. tax purposes to be considered a Netherlands corporation, and will be eligible to claim treaty benefits to the same extent as any other corporation resident in the Netherlands.

Article 5 - PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment." This definition is relevant under several articles of the Convention. The existence of a permanent establishment in a Contracting State is necessary under Article 7 (Business Profits) for the taxation by that State of the business profits of a resident of the other Contracting State. Since the term "fixed base" in Article 15 (Independent Personal Services) is understood by reference to the definition of "permanent establishment," this Article is also relevant for purposes of Article 15. Articles 10, 12 and 13 (dealing with dividends, interest, and royalties, respectively) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment or fixed base that the recipient has in the source State.

This Article follows closely both the U.S. and OECD Model provisions. It does not differ significantly from the definition of a permanent establishment in the prior Convention.

Paragraph 1 provides the basic definition of the term "permanent establishment." As used in the Convention, the term means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 2 contains a list of fixed places of business that will constitute a permanent establishment. The list is illustra-

tive and non-exhaustive. According to paragraph 2, the term permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, quarry or other place of extraction of natural resources.

Paragraph 3 provides rules to determine when a building site, or a construction or installation project constitutes a permanent establishment. Only if the site, project, etc. lasts for more than twelve months does it constitute a permanent establishment. The twelve-month test applies separately to each individual site or project. The twelve-month period begins when work (including preparatory work carried on by the enterprise) physically begins in a Contracting State. A series of contracts or projects that are interdependent both commercially and geographically are to be treated as a single project for purposes of applying the twelve-month threshold test. For example, the construction of a housing development would be considered a single project even if each house in the development is constructed for a different purchaser. If the twelve-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that the work in that State began. This interpretation of the Article is based on the Commentaries to paragraph 3 of Article 5 of the OECD Model, which contains language almost identical to that in the Convention. This interpretation, therefore, constitutes the generally accepted international interpretation of the language in paragraph 3 of Article 5 of the Convention.

Unlike the U.S. Model, drilling rigs operating offshore on the continental shelf of one of the States are not covered by this construction site rule. Such activities are dealt with under Article 27 (Offshore Activities).

Paragraph 4 contains exceptions to the general rule of paragraph 1 that a fixed place of business through which a business is carried on constitutes a permanent establishment. The paragraph lists activities that may be carried on through a fixed place of business, but that will not give rise to a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise will not constitute a permanent establishment of that enterprise. The maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise will not give rise to a permanent establishment of the first-mentioned enterprise. The maintenance of a fixed place of business solely for activities that have a preparatory or auxiliary character for the enterprise, such as advertising, the supply of information or scientific activities, will not constitute a permanent establishment of the enterprise. Finally, a combination of these activities will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character. This combination rule differs from that in the U.S. Model. In the U.S.

Model, any combination of otherwise excepted activities is not deemed to give rise to a permanent establishment, without the additional requirement that the combination, as distinct from each constituent activity, be preparatory or auxiliary. It is assumed that if preparatory or auxiliary activities are combined, the combination generally will also be of a character that is preparatory or auxiliary. If, however, this is not the case, a permanent establishment may result from a combination of activities.

Paragraphs 5 and 6 specify the circumstances under which an agent will constitute a permanent establishment of the principal. Under paragraph 5, a dependent agent of an enterprise will be deemed to be a permanent establishment of the enterprise, if the agent has and habitually exercises an authority to conclude contracts in the name of that enterprise. If, however, the agent's activities are limited to those activities specified in paragraph 4, and therefore would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the agent will not be a permanent establishment of the enterprise.

Under paragraph 6, an enterprise will not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of its business.

Paragraph 7 clarifies that a company that is a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it controls, or is controlled by, a company that is a resident of that other Contracting State, or that carries on business in that other Contracting State. The determination of whether or not a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether or not a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

Article 6 - INCOME FROM REAL PROPERTY

Paragraph 1 provides that income of a resident of a Contracting State derived from real property situated in the other Contracting State may be taxed in the Contracting State in which the property is situated. As clarified in paragraph 3, the income referred to in paragraph 1 means income from any use of real property, including, but not limited to, income from direct use by the owner and rental income from the letting of real property. Income from real property also includes income from agriculture and forestry. This Article does not grant an exclusive taxing right to the situs State, but merely grants it the primary right to tax.

The Article does not impose any limitation in terms of rate or form of tax on the situs State.

Paragraph 2 provides that the term "real property" has the same meaning that it has under the law of the situs State. In addition, the paragraph specifies certain classes of property which, regardless of internal law definitions, are to be included within the meaning of the term for purposes of the Convention. The definition of "real property" for purposes of Article 6, however, does not include stock in a real property holding company and other interests that are covered in paragraph 1(b) of Article 14 (Capital Gains).

Paragraph 4 clarifies that the situs State may tax the real property income of a resident of the other Contracting State even in the absence of a permanent establishment or fixed base in the situs State, notwithstanding the requirements of Articles 7 (Business Profits) and 15 (Independent Personal Services) that in order to be taxable, income must be attributable to a permanent establishment or fixed base, respectively. Thus, the situs State may tax income from real property of an enterprise and income from real property used for the performance of independent personal services, regardless of whether the enterprise or individual has a permanent establishment in the situs State.

Paragraph 5 contains the provision in the U.S. Model for a binding election by the taxpayer to be taxed on real property income on a net basis. Frequently, when both Contracting States provide for net basis taxation under internal law, this paragraph is not included. Although both Contracting States provide for net basis taxation, the paragraph was included in the Convention at the request of the Netherlands.

Paragraph 6 clarifies that the term "real property" includes rights to the exploration or exploitation of the sea bed and sub-soil, and the natural resources found in the sea bed and sub-soil, and that such real property is located in the State in which the sea bed, sub-soil or resources are located. The paragraph also clarifies that such rights or property are considered to pertain to a permanent establishment in that State in the same manner that any real property in a State is considered to pertain to a permanent establishment there. This paragraph is not found in any Model treaty. However, it is consistent with the definition of immovable property in Article 6 of the OECD Model, which includes "rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources." Furthermore, the provision is consistent with subparagraphs (b) and (c) of paragraph 1 of Article 3 (General Definitions) which provides that the terms "the United States" and "the Netherlands" include their continental shelves.

Model, any combination of otherwise excepted activities is not deemed to give rise to a permanent establishment, without the additional requirement that the combination, as distinct from each constituent activity, be preparatory or auxiliary. It is assumed that if preparatory or auxiliary activities are combined, the combination generally will also be of a character that is preparatory or auxiliary. If, however, this is not the case, a permanent establishment may result from a combination of activities.

Paragraphs 5 and 6 specify the circumstances under which an agent will constitute a permanent establishment of the principal. Under paragraph 5, a dependent agent of an enterprise will be deemed to be a permanent establishment of the enterprise, if the agent has and habitually exercises an authority to conclude contracts in the name of that enterprise. If, however, the agent's activities are limited to those activities specified in paragraph 4, and therefore would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the agent will not be a permanent establishment of the enterprise.

Under paragraph 6, an enterprise will not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of its business.

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Article 7 - BUSINESS PROFITS

This Article provides rules for the taxation by one of the States of the business profits of an enterprise of the other. Paragraph 1 contains the basic rule that business profits of an enterprise of one State may not be taxed by the other State unless the enterprise carries on business in that other State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated there. Where this condition is met, the State in which the permanent establishment is situated may tax the income of the enterprise, but only so much of the income as is attributable to the permanent establishment. This rule differs from its counterpart in the prior Convention, which contained a limited force of attraction rule. That rule permitted the State in which the permanent establishment is situated to tax income of the enterprise even if not attributable to the permanent establishment, if the income was derived from sources in that State from the sale of goods or merchandise of the same kind as that sold through the permanent establishment or from other transactions of the same kind as those effected through the permanent establishment.

Paragraph 2 provides rules for the attribution of business profits to a permanent establishment. It provides that the Contracting States will attribute to a permanent establishment the profits that it would have earned had it been an independent entity, engaged in the same or similar activities under the same or similar circumstances. The computation of the business profits attributable to a permanent establishment under this paragraph is subject to the rules of paragraph 3 for the allowance of expenses incurred for the purpose of earning the income. The profits attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, certain items of foreign source income described in Code section 864(c)(4)(B) may be attributed to a U.S. permanent establishment of a Netherlands enterprise and subject to tax in the United States. The concept of "attributable to" in the Convention is narrower than the concept of "effectively connected" in Code section 864(c). The limited "force of attraction" rule in Code section 864(c)(3), therefore, is not applicable under the Convention.

Paragraph 2 differs in one respect from the comparable paragraph in the U.S. Model, but conforms in this respect to the OECD Model. In the U.S. Model, the permanent establishment is treated as if it were a "distinct and <u>independent</u> enterprise," and the reference to it dealing wholly independently with the enterprise of which it is a permanent establishment is deleted. The U.S. Model language is intended to make clear that, as described in paragraph 10 of the OECD Commentaries to Article 7, the permanent establishment is to be treated as if it were a totally independent enterprise, <u>i.e.</u>, one that deals independently with all related companies, not just its home office. In the course of the negotiations, the Netherlands negotiators made clear

that they subscribed to the interpretation in the OECD Commentaries, but preferred to retain the language from the OECD Model. Thus, there should be no difference in application between paragraph 2 of Article 7 and its analogue in the U.S. Model.

Paragraph III. of the Memorandum of Understanding clarifies that in determining the profits of a permanent establishment, only the portion of the income of the enterprise of which the permanent establishment is a part that is attributable to the actual activity of the permanent establishment is to be taken into account. The Memorandum gives an example of an enterprise that has a contract for the survey, supply, installation or construction of industrial, commercial or scientific equipment or premises. If that enterprise has a permanent establishment, the profits attributable to the permanent establishment are determined on the basis of that part of the contract effectively carried out by the permanent establishment. The profits related to the part of the overall contract carried out by the head office are not subject to tax by the State in which the permanent establishment is situated. As noted above, profits may be attributable to the permanent establishment even if they are not from sources in the State in which the permanent establishment is located.

Paragraph 3 of the Article provides that in determining the business profits of a permanent establishment, deductions shall be allowed for expenses incurred for the purposes of the permanent establishment. Deductions are to be allowed regardless of where the expenses are incurred. The paragraph specifies that among the expenses for which deductions are allowed are expenses for research and development, interest and other similar expenses. Also included is a reasonable amount of executive and general administrative expenses. The language of this paragraph differs slightly from that in the U.S. Model. The U.S. Model refers to a "reasonable allocation" of the enumerated expenses; the Convention omits this reference. During the negotiations, the Netherlands was concerned that the U.S. Model language could be construed to require both Contracting States to apply the expense allocation rules found in U.S. law, as, for example, in regulation sections 1.861-8 and 1.882-5. Leaving out the reference to "reasonable allocation" is understood to make clear that each State may use its own rules, whether based on tracing or allocation, for attributing expenses to a permanent establishment.

Paragraph 3 of Article 24 (Basis of Taxation) refers to paragraphs 1 and 2 of Article 7. It provides that any income, gain or expense attributable to a permanent establishment during its existence is taxable or deductible in the State in which the permanent establishment is situated even if the payment is deferred until after the permanent establishment no longer exists. This paragraph incorporates into the Convention the rule of Code section 864(c)(6).

Paragraph 4 provides that no business profits will be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent establishment that performs more than one function for the enterprise, including purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's manufacturing operation and sell the manufactured output. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable to its purchasing activities. If the sole activity were the purchasing of goods or merchandise for the enterprise the issue of the attribution of income would not arise, because, under subparagraph 4(d) of Article 5 (Permanent Establishment), there would be no permanent establishment.

Paragraph 5 provides that only those business profits derived from a permanent establishment's assets or activities are to be attributed to the permanent establishment. This rule clarifies, as noted in connection with paragraph 2 of the Article, that the Code's limited "force of attraction" principle is not incorporated into the Convention. To assure continuous and consistent tax treatment, the same method for determining the profits of a permanent establishment is to be used from year to year, unless there is good reason to change. This paragraph differs from the U.S. Model provision in only one respect. In the U.S. Model, the rules of the paragraph apply "for the purposes of this Convention," while in the Convention, as in the OECD Model, the paragraph applies "for the purposes of the preceding paragraphs." Since, when other Articles deal with the taxation of business profits, it is always by reference to Article 7, there is no practical difference between the two versions.

Paragraph 6 explains the relationship between the provisions of Article 7 and other provisions of the Convention. Under paragraph 6, where business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will, except where they specifically provide to the contrary, take precedence over the provisions of Article 7. Thus, for example, the taxation of interest will be determined by the rules of Article 12 (Interest), and not by Article 7, unless, as provided in paragraph 3 of Article 12, the interest is attributable to a permanent establishment, in which case the provisions of Article 7 apply.

Paragraph 7 contains a rule not found in the U.S. Model or in most U.S. income tax treaties. The paragraph states that the U.S. Federal excise tax on insurance premiums paid to foreign insurers, to the extent that it is a covered tax under paragraph 1(b) of Article 2 (Taxes Covered) (i.e., to the extent that the risks are not reinsured with a person not entitled to exemption from the tax under this or another Convention), will not be imposed on insurance

or reinsurance premiums paid to an insurance business carried on by a Netherlands enterprise, whether or not the business is carried on through a U.S. permanent establishment. This provision of the Convention merely restates the result that obtains under a combination of U.S. law and other provisions of the Convention. Since the excise tax is generally a covered tax under Article 2 (Taxes Covered), the United States may not, pursuant to the provisions of paragraph 1 of Article 7, impose the tax on the income of any Netherlands enterprise that is not attributable to a permanent establishment in the United States. Under Code section 4373, the tax may not be imposed on any amount that is effectively connected with the conduct of a trade or business in the United States. Since any amount attributable, under the Convention, to a permanent establishment in the United States will also be effectively connected with a U.S. trade or business, the tax may also not be imposed on any income of a Netherlands enterprise that is attributable to a permanent establishment in the United States.

The Convention does not contain a definition of the term "business profits," as found in paragraph 7 of Article 7 of the U.S. Model. The reason for the inclusion of the definition in Article 7 of the U.S. Model is to make clear that business profits includes two classes of income which, in some countries, are subject to gross basis taxation at source and in the 1977 OECD Model Convention are treated as royalties under Article 12. These classes of income are income from the rental of tangible personal property and income from the rental or licensing of motion picture films or works on film, tape or other means of reproduction for use in radio or television broadcasting. In the Convention neither of these classes of income is included within the definition of royalties in Article 13 (Royalties). Since Article 7 applies to all business profits unless dealt with specifically under another article, these classes of income generally are considered business profits for purposes of the Convention. In some circumstances they might be treated by the Netherlands as "other income" under Article 23 (Other Income). The result, however, will be the same in either event -- no taxation at source, unless the income is attributable to a permanent establishment, in which case it would be taxable on a net basis by the State in which the permanent establishment is located. The absence of a definition of "business profits" in the Convention, therefore, does not affect the taxation of these classes of income.

This Article is subject to the saving clause of paragraph 1 of Article 24 (Basis of Taxation). Thus, if, for example, a citizen of the United States who is a resident of the Netherlands derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may (subject to the special foreign tax credit rules of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation)) tax those profits as part of the worldwide income of the citizen, notwithstanding the fact that this Article generally would

exempt such income of a Netherlands resident from U.S. tax.

As with any benefit of the Convention, the enterprise claiming the benefit of Article 7 must be entitled to the benefit under the provisions of Article 26 (Limitation on Benefits).

Article 8 - SHIPPING AND AIR TRANSPORT

This Article provides rules governing the taxation of profits from the operation of ships and aircraft in international traffic. The term "international traffic" is defined in subparagraph 1(h) of Article 3 (General Definitions). It is understood, based on the provisions of paragraph 2 of Article 1 (General Scope), that any benefits to which a resident of one of the States is entitled by virtue of the exchange of notes between the United States and the Netherlands under the authority of Code section 883, will continue to be available regardless of any provisions to the contrary in the Convention.

Paragraph 1 provides that profits derived by an enterprise of one of the States from the operation of ships or aircraft in international traffic shall be taxable only in that State. By virtue of paragraph 6 of Article 7 (Business Profits), profits of an enterprise of a Contracting State that are exempt in the other Contracting State under this paragraph remain exempt even if the enterprise has a permanent establishment in that other Contracting State.

Paragraph 2 deals with certain income from the rental of ships or aircraft in international traffic. As indicated in paragraph 5 of the OECD Commentaries to Article 8, income of an enterprise of a Contracting State from the rental of ships or aircraft on a full basis (_i.e._, with crew) is considered to be income from the operation of ships and aircraft and is, therefore, exempt from tax in the other Contracting State under paragraph 1. Paragraph 2 extends the coverage of the Article to certain income from the bare-boat leasing of ships and aircraft. Unlike paragraph 2 in the U.S. Model, however, income from bareboat rentals of ships or aircraft is included within the definition of profits from the operation of ships or aircraft in international traffic in the Convention only to the extent that the rental profits are incidental to profits from the operation of ships and aircraft. Thus, an enterprise that is not in the business of operating ships or aircraft in international traffic and that derives income from renting ships or aircraft would not be able to claim the benefits of Article 8. Income from the non-incidental leasing of ships or aircraft, even if the ships or aircraft are used in international traffic, is treated as business profits. Such non-incidental rental income consequently is taxable in the source State only if it is attributable to a permanent establishment which the lessor has in the source State. It is understood that if, for example, a

bank is a resident of one of the States and has a permanent establishment in the other State, and that bank leases an aircraft to an airline in the other State, the rental income will not be attributable to the permanent establishment if the permanent establishment was not involved in negotiating or concluding the lease agreement. The rental income consequently will not be subject to tax by that other State. Similarly, if the activities of the bank in that other State are not sufficient to rise to the level of a permanent establishment, the lease income will not be taxable in that other State.

Paragraph 3 clarifies that paragraph 1 applies equally to a proportionate share of the profits derived by an enterprise of a Contracting State from participation in a pool, joint business or international operating agency. This proportionate share is treated as income derived directly from the operation of ships or aircraft in international traffic.

Unlike the U.S. Model, Article 8 does not deal with income from the use or rental of containers (including equipment for their transport) that are used for the transport of goods in international traffic. Under the U.S. Model, such income is treated the same as income from the operation in international traffic of ships or aircraft, and, therefore, is taxable only by the State of residence of the enterprise. Under the Convention, such income is treated as business profits, in the same manner as any other income from the rental of tangible personal property, regardless of whether the recipient of the income is a shipping or airline company and its container income is incidental to its income from the operation of ships or aircraft, or whether the recipient is a container leasing company. In either case, if an enterprise of one State derives income from the use or rental of containers, the other State may tax the income only if it is attributable to a permanent establishment in that other State, and may tax only on a net basis.

The taxation of gains from the alienation of ships, aircraft or containers is dealt with in paragraph 4 of Article 14 (Gains).

This Article is subject to the saving clause of paragraph 1 of Article 24 (Basis of Taxation). The United States, therefore, may, subject to the special foreign tax credit rules of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation), tax the shipping or air transport profits of a resident of the Netherlands if that Netherlands resident is a citizen of the United States.

As with any benefit of the Convention, the enterprise claiming the benefit of this Article must be entitled to the benefit under the provisions of Article 26 (Limitation on Benefits).

Article 9 - ASSOCIATED ENTERPRISES

This Article incorporates into the Convention the general principles of section Code 482. It provides that when related persons (i.e., associated enterprises described in subparagraphs 1(a) and 1(b)) engage in transactions that are not at arm's length, the Contracting States may make appropriate adjustments to the taxable income of such related persons to reflect the income these persons would have earned with respect to such transactions had there been an arm's length relationship between the persons. The prior Convention contains similar rules.

Paragraph 1 deals with the circumstance where an enterprise of a Contracting State is related to an enterprise of the other Contracting State, and the enterprises make arrangements or impose conditions between themselves in their commercial or financial relations different from those that would be made between independent persons. Under these circumstances a Contracting State may adjust the income (or loss) of the enterprise situated in that State to reflect the income that would have been earned in the absence of such a relationship. The paragraph specifies what the term "associated enterprise" means in this context. An enterprise of one Contracting State is associated with an enterprise of the other Contracting State if it participates directly or indirectly in the management, control, or capital of the other. Two enterprises also are associated if any third person or persons participate directly or indirectly in the management, control, or capital of both. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable.

Paragraph 1 contains additional language that is not found in the U.S. Model. This addition clarifies that cost sharing or general services agreements between associated enterprises are not necessarily to be included among the conditions "made or imposed between two enterprises" that are referred to in the first sentence of paragraph 1. Thus, the mere presence of a cost-sharing, or similar, agreement between two related parties does not by itself indicate that the two parties have entered into a non-arm's length transaction giving rise to an adjustment under paragraph 1. However, any such arrangement may be examined to determine whether, in fact, it does constitute such a transaction.

Paragraph 2 provides that where a Contracting State has made an adjustment to the profits of an enterprise of that State that is consistent with the provisions of paragraph 1 (i.e., that was appropriate to reflect arm's length conditions), and the associated enterprise in the other State has been subject to tax on those same profits, that other Contracting State is obligated to make a corresponding, or correlative, adjustment to the tax liability of that associated enterprise. The Contracting State making such an adjustment will take the other provisions of the Convention, where

relevant, into account. For example, if the effect of a correlative adjustment is to treat a Netherlands corporation as having made a distribution of profits to its U.S. parent corporation, the provisions of Article 10 (Dividends) will apply, and the Netherlands may impose a withholding tax on the dividend. The rate of the tax will be determined by the provisions of Article 10 (Dividends). The competent authorities are authorized to consult, if necessary, to resolve any differences in the application of these provisions. For example, there may be a disagreement over whether an adjustment made by a Contracting State under paragraph 1 was appropriate.

Article 9 of the Convention does not contain a counterpart to paragraph 3 of Article 9 of the U.S. Model. That paragraph does not grant authority that does not otherwise exist; rather, it merely makes clear that, despite the somewhat limited language in paragraph 1 (e.g., the paragraph does not deal with adjustments to credits), the rights of the Contracting States to apply internal law provisions relating to adjustments between related parties are fully preserved. Such adjustments -- the distribution, apportionment, or allocation of income, deductions, credits or allowances -- are permitted even if they are different from, or go beyond, those authorized by paragraph 1 of the Article, so long as they accord with the general principles of paragraph 1 (i.e., that the adjustment reflects what would have transpired had the related parties been acting at arm's length). Thus, the absence of paragraph 3 in the Convention does not limit either State's right to implement its own statutory rules relating to adjustments intended to reflect transactions between unrelated parties. This conclusion derives from the view of both States that paragraph 1 of the Article is intended to be illustrative and not restrictive. For example, while paragraph 1 explicitly allows adjustments to deductions in computing taxable income, it does not preclude adjustments to tax credits if such adjustments can be made under internal law, despite the lack of express authority in Article 9 to make such adjustments.

Paragraphs IV. and V. of the Memorandum of Understanding relate to Article 9. Paragraph IV. deals with the rules of both States for determining the appropriate amount of interest deductions allowed to their enterprises. The paragraph makes clear that the appropriate deduction may be determined by reference not only to the amount of interest paid with respect to a particular debt claim (i.e., is the rate of interest charged appropriate), but also to the overall debt capital of the enterprise (i.e., is the capital structure of the enterprise appropriate). Any adjustment to the amount of the deduction for interest must be consistent with the arm's length principles of paragraph 1 of Article 9 as those principles are examined and explained in OECD publications regarding thin capitalization. A 1986 report on thin capitalization by the Committee on Fiscal Affairs of the OECD supports the view expressed in paragraph IV. that Article 9 is

relevant for determining the appropriate amount of interest either with respect to a particular debt claim or by reference to the overall capital structure of the enterprise.

Paragraph V. of the Memorandum of Understanding clarifies the relationship between Article 29 (Mutual Agreement Procedure) and Article 9. Paragraph V. first notes that under Article 29, the competent authorities should attempt to resolve any double taxation that may arise as a result of the application by one of the States of its rules relating to such matters as thin capitalization, earnings stripping or transfer pricing. It then confirms that the competent authorities should make their determination based on the arm's length principles of paragraph 1 of Article 9. It finally notes that, consistent with the mutual agreement procedures of other income tax Conventions, an agreement reached by the competent authorities under Article 29 in response to an adjustment by one of the States under paragraph 1 of Article 9, may result either in a correlative adjustment by the other State or in a full or partial readjustment by the first State in its original adjustment.

If a correlative adjustment is made under paragraph 2, it is to be implemented pursuant to paragraph 2 of Article 29 (Mutual Agreement Procedure), notwithstanding any time limits or other procedural limitations in the law of the Contracting State making the adjustment, provided that the competent authority making the correlative adjustment has received notification of the case within six years from the end of the taxable year to which the case relates. (See the explanation of Article 29 for an explanation of the operation of the notification requirement.) The saving clause of paragraph 1 of Article 24 (Basis of Taxation) does not apply to paragraph 2 of Article 9 (see the exceptions to the saving clause in subparagraph a) of paragraph 2 of Article 24). Thus, even if the statute of limitations has run, or there is a closing agreement between the Internal Revenue Service and the taxpayer, a refund of tax can be made in order to implement a correlative adjustment arising under paragraph 2 of Article 9. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because, under paragraph 2 of Article 1 (General Scope) the Convention cannot restrict any statutory benefit.

The United States intends that its regulations under Code section 482 will adhere fully to the arm's length standard. In particular, the "commensurate with income" approach for determining royalty rates with respect to intangible property transferred between related parties is to be applied consistently with the arm's length standard. The commensurate with income approach recognizes that in certain cases it may be appropriate under the arm's length standard to make periodic adjustments to royalty rates between related parties. In particular, as noted in a 1992 OECD Report on the United States Proposed Regulations under Section 482, it is not always possible for the Internal Revenue Service to know what profits were reasonably foreseeable at the time that an

intangible was transferred. In such cases and others periodic adjustments may be warranted. It is anticipated that the commensurate with income approach and the section 482 regulations in general will be applied in a manner consistent with the principles underlying paragraph 1 of Article 9.

Article 10 - DIVIDENDS

Article 10 provides rules for both source and residence country taxation of dividends and similar amounts paid by a company resident in one State to a resident of the other. Generally, the article limits the source country's right to tax dividends and amounts treated as dividends or dividend equivalents.

Paragraph 1 preserves the residence country's general right to tax dividends arising in the source country by permitting a Contracting State to tax its residents on dividends received from a company that is a resident of the other Contracting State.

Paragraph 2 grants the source country the right to tax dividends paid by a company that is a resident of that country. Subject to special rules for dividends paid by certain companies, described below, if the beneficial owner of the dividend is a resident of the other Contracting State, the source country tax is limited to 5 percent of the gross amount of the dividend if the beneficial owner is a company that holds directly at least 10 percent of the voting power of the company paying the dividend. Source country taxation is limited to 15 percent of the gross amount of the dividend in all other cases. Indirect ownership of voting shares (e.g., through tiers of corporations) and direct ownership of nonvoting shares are not considered for purposes of determining eligibility for the 5 percent direct dividend rate. Withholding rates for dividends under the prior Convention are the same, except that the requirements for applicability of the 5 percent rate are somewhat different.

Special limitations on the rate of source country taxation are provided in paragraph 2 for dividends paid by U.S. Regulated Investment Companies and Real Estate Investment Trusts ("RICs" and "REITs") and by Netherlands "beleggingsinstellings" (as that term is defined in Article 28 of the Netherlands Corporation Tax Act). Dividends paid by RICs and beleggingsinstellings are denied the 5 percent direct dividend rate and subjected to the 15 percent portfolio dividend rate regardless of the percentage of voting shares held directly by a corporate recipient of the dividend. Dividends paid by a REIT and dividends paid by a beleggingsinstelling that invests in real estate to the same extent as is required of a REIT are generally taxed at source at full statutory rates. A beleggingsinstelling will be considered to invest in real estate to the same extent as is required of a REIT if it would satisfy the requirements under Code sections 856(c)(3)

and (5). However, in two circumstances dividends paid by such entities are taxed at source at the 15 percent portfolio dividend rate -- if the beneficial owner of the dividend is an individual who owns less that a 25 percent interest in the REIT or the beleggingsinstelling, or if the REIT dividend is owned by a beleggingsinstelling or if the dividend paid by the beleggingsinstelling is beneficially owned by a RIC or a REIT.

The denial of the 5 percent withholding rate at source to all RIC, REIT and beleggingsinstellings shareholders, and the denial of the 15 percent rate to most shareholders of REITs and their Dutch equivalents, is intended to prevent the use of these conduit entities to gain unjustifiable benefits for certain shareholders. For example, a Netherlands corporation that wishes to hold a diversified portfolio of U.S. corporate shares may hold the portfolio directly and pay a U.S. withholding tax of 15 percent on all of the dividends that it receives. Alternatively, it may place the portfolio of U.S. stocks in a RIC, in which the Netherlands corporation owns most of the shares, but in which the corporation has arranged to have a sufficient number of small shareholders to satisfy the RIC diversified ownership requirements. Since the RIC is a pure conduit, there are no U.S. tax costs to the Netherlands corporation of interposing the RIC as an intermediary in the chain of ownership. In the absence of the special rules in paragraph 2, however, the interposition would transform portfolio dividends into direct investment dividends, taxable only at 5 percent.

Similarly, a resident of the Netherlands may hold U.S. real property directly, and pay U.S. tax either at a 30 percent rate on the gross income or, generally, at the rates specified in Code sections 1 or 11 on the net income. As in the preceding example, by placing the real estate holding in a REIT, the Dutch investor could transform real estate income into dividend income, and in the process, absent the special rule, transform, at no tax cost, high-taxed income into much lower-taxed income. In the absence of the special rule, if the REIT shareholder is a Netherlands corporation that owns at least a 10 percent interest in the REIT, the withholding rate would be 5 percent; in all other cases it would be 15 percent. In either event, with one exception, a tax of 30 percent or more would be significantly reduced. The exception is the relatively small individual investor who might be subject to a U.S. tax of 15 percent of the net income even if he earned the real estate income directly. Under the special rule in paragraph 2, such individuals, defined as those holding less than a 25 percent interest in the REIT, remain taxable at source at a 15 percent rate.

The term "beneficial owner", as used in paragraph 2, is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the dividend income is attrib-

utable for tax purposes under the laws of the source state. Thus, if a dividend paid by a corporation of one of the States is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by the nominee on behalf of a resident of that other State would be entitled to the benefits.

Paragraph VI. of the Memorandum of Understanding elaborates on the definition of dividends and on the concept of beneficial ownership of dividends. It specifies that the beneficial owner of dividends who, instead of holding directly the shares themselves, holds depository receipts or trust certificates representing the underlying shares, may claim the benefits of reduced source country taxation under paragraph 2 of the Article. The paragraph also deals with the status under Article 10 of dividends paid in respect of shares that have been loaned. It makes clear that when a person loans shares (or other rights that generate income that is treated as income from shares for tax purposes) and receives from the borrower of the shares an obligation to pay any amounts that the borrower receives as dividends during the term of the loan, the lender of the shares or other rights is treated as the beneficial owner of the dividends paid with respect to such shares or other rights. That person is, therefore, entitled to the benefits of paragraph 2 of Article 10 with respect to such payments.

Paragraph 3 makes clear that paragraph 2 does not affect the taxation of the profits out of which the dividends are paid, but affects the taxation only of the dividend itself.

Paragraph 4 defines the term dividends as used in the Convention. Paragraph 4 generally conforms to paragraph 3 of Article 10 of the OECD Model. The term includes income from shares or other rights participating in profits, as well as other income derived from other corporate rights that is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident. In the case of the Netherlands, the term also includes income from profit sharing bonds, and in the case of the United States, the term includes income from debt obligations that carry the right to participate in profits.

Paragraph 5 excludes dividends paid with respect to holdings that form part of the business property of a permanent establishment or fixed base from the general source country limitations of paragraph 2. Such dividends will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the state in which the permanent establishment or fixed base is located, as modified by Articles 7 (Business Profits) or 15 (Independent Personal Services) of the Convention.

The rule in paragraph 3 of Article 24 (Basis of Taxation)

dealing with deferred income and expenses of a permanent establishment or fixed base applies to paragraph 5 of this Article. Thus, dividend income that is attributable to a permanent establishment or fixed base, but is deferred until after the permanent establishment or fixed base no longer exists, may nevertheless be taxed by the State in which the permanent establishment or fixed base was located.

Paragraph 6 bars one State from imposing any tax on dividends paid by a company resident in the other State, except insofar as such dividends are otherwise subject to net basis taxation in the first-mentioned Contracting State because such dividends are paid to a resident of such first-mentioned Contracting State, or the holding in respect of which the dividends are paid forms part of the business property of a permanent establishment or pertains to a fixed base situated in such first-mentioned State. Furthermore, except as provided in Article 11 (Branch Tax), paragraph 6 prevents one State from taxing a company resident in the other on its undistributed profits regardless of where those undistributed profits arise.

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of paragraph 1 of Article 24 (Basis of Taxation) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation), as if the Convention had not come into effect.

As with any benefit of the Convention, a resident of one of the States claiming the benefit of this Article must be entitled to the benefit under the provisions of Article 26 (Limitation on Benefits).

Article 11 - BRANCH TAX

Article 11 provides for the imposition of a branch profits tax. Paragraph 1 provides the basic authority under the Convention for a State to impose an additional tax (e.g., a branch profits tax such as that imposed by section 884(a) of the Code) on a company that is resident in the other Contracting State and that has a permanent establishment in the first-mentioned State or that is subject to net basis taxation in such State under Article 6 (Income from Real Property) or under paragraph 1 of Article 14 (Capital Gains). Paragraph 1 defines the base to which the tax is applied. That base is the portion of the business profits of a company attributable, under the Convention, to the permanent establishment and the net income subject to tax under Article 6 or paragraph 1 of Article 14, reduced by corporate taxes (other than the branch tax) paid by the branch, and further reduced, but not below zero, by the increases in net equity attributable to the permanent

establishment, and increased, but not in excess of accumulated profits, for decreases in net equity attributable to the permanent establishment. This definition of the base subject to the branch tax is consistent with the definition under U.S. law of the dividend equivalent amount that is subject to the branch profits tax under Code section 884. Paragraph 4 confirms this result by providing that in the case of the United States, the base of the tax is the "dividend equivalent amount," as the term is defined under United States law, and as that statutory definition may be amended from time to time, but only to the extent that the amended definition remains in conformity with the principles described in paragraph 1.

For example, the United States may impose its branch profits tax on business profits of a Netherlands company attributable to a permanent establishment in the United States. In addition, the United States may impose its branch profits tax on income of a Netherlands corporation subject to taxation on a net basis because the Netherlands corporation has elected under Code section 882(d) to treat income from real property not otherwise taxed on a net basis as effectively connected income, or because the gain arises from the disposition of a United States Real Property Interest other than an interest in a United States corporation. The United States may not impose its branch profits tax on the business profits of a Netherlands corporation that are effectively connected with a U.S. trade or business but that are not attributable to a permanent establishment and are not otherwise subject to U.S. taxation under Article 6 or paragraph 1 of Article 14.

Although the Article is drafted in a reciprocal fashion, thus allowing both States to impose a branch tax, as of the time of signature of the Convention only the United States imposed such a tax.

Paragraph 2 of Article 11 provides that the term "accumulated profits," as used in paragraph 1 in defining the base of the branch tax, refers only to profits earned in the taxable years for which the Convention was in effect, less the amount of profits that were taxed under Article 11. This rule effectively limits the United States' right to impose its branch profits tax to profits earned in taxable years after the effective date of the Convention. Given that the prior Convention prohibits imposition of the tax, the Dutch delegation regarded its agreement to permit imposition of the branch tax in any form as a concession on its part. Since the United States delegation, in conformity with the directive of Congress to renegotiate those treaties that did not permit the branch tax, insisted that the Convention permit the imposition of the tax, the delegations compromised by agreeing to a provision permitting the U.S. to impose its branch profits tax but not with respect to earnings attributable to periods during which the United States was barred by treaty from imposing the tax.

Paragraph 3 provides that the branch profits tax permitted by this Article shall not be imposed at a rate exceeding the direct dividend withholding rate of five percent that is provided for in paragraph 2(a) of Article 10 (Dividends).

Paragraph 5 provides that the branch tax imposed by paragraph 1, consistently with U.S. law, will not be imposed on gain from the disposition of shares or other corporate rights that are subject to tax under paragraph 1 of Article 14 (Capital Gains), i.e., shares in a company the greater part of the assets of which consist of real property situated in the State of residence of the company. It may, however, be imposed on other real property gains that are subject to tax under paragraph 1 of Article 14.

As with any benefit of the Convention, a corporation that is a resident of one of the States claiming the benefits of this Article must be entitled to those benefits under the provisions of Article 26 (Limitation on Benefits).

Article 12 - INTEREST

Article 12 provides rules for source and residence country taxation of interest.

Paragraph 1 grants to the residence State the exclusive right to tax interest derived and beneficially owned by its residents. Thus, the exemption at source for interest in the prior Convention is generally carried forward to this Convention.

Paragraph 2 defines the term "interest" as used in the Convention to mean income from debt claims of every kind, whether or not the claim is secured by a mortgage. The term "interest," however, does not include income from debt claims that carry the right to participate in the profits of the debtor. Such income is included within the definition of dividends in Article 10 (Dividends) and is, therefore, subject to the provisions of that Article. Thus, for example, income from a debt obligation of a Netherlands resident that carries the right to participate in profits is not covered by Article 12, even if such income is treated as interest under the law of the United States. If, however, a U.S. parent receives a Netherlands source payment from a Netherlands subsidiary that is treated as a dividend for purposes of Netherlands taxation, but is characterized as interest under U.S. law, the U.S. parent will not be allowed a deemed-paid foreign tax credit with respect to Netherlands income tax attributable to that payment.

The definition of interest in paragraph 2 includes income from Government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds or debentures. The definition also includes as interest an excess

inclusion with respect to a residual interest in a real estate mortgage investment conduit. A special rule is provided in paragraph 7 for this category of interest. Penalty charges for late payment are excluded from the definition of interest.

Paragraph 3 provides an exception to the general rule of Paragraph 1 that bars a source country tax on interest. The exception applies in cases where the beneficial owner of the interest carries on business through a permanent establishment in the source State or performs independent personal services from a fixed base situated in the source State and the debt claim in respect of which the interest is paid forms part of the business property of such permanent establishment or fixed base. In such cases the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services) will apply and the source State will generally retain the right to impose tax on such interest income.

The rule in paragraph 3 of Article 24 (Basis of Taxation) dealing with deferred income and expenses of a permanent establishment or fixed base applies to paragraph 3 of this Article. Thus, interest income that is attributable to a permanent establishment or fixed base, but is deferred until after the permanent establishment or fixed base no longer exists, may nevertheless be taxed by the State in which the permanent establishment or fixed base was located.

Paragraph 4 provides a source rule for interest. It provides that interest shall be deemed to arise in a State when the payer is the State itself, or a political subdivision, local authority or resident of that State. There is an exception, however, to the general rule that interest arises in the State of residence of the payer. The exception arises when the payer, even if he is a third-State resident, has a permanent establishment or a fixed base in one of the States and the interest in connection with which the interest is paid was incurred in connection with, and is borne by, that permanent establishment or fixed base. The exception also applies in the case where the person paying the interest is subject to the branch tax under Article 11 (Branch Tax) and the interest paid is allocable to the income subject to the branch tax. In those cases, the interest is deemed to arise in the State in which the permanent establishment or fixed base is situated or in which the income is subject to the branch tax.

Paragraph 5 deals with cases where there is a special relationship between the payer and the beneficial owner of interest. The provisions of Article 12 apply only to interest payments that would have been made absent such special relationships (i.e., an arm's length interest payment). Any excess amount of interest paid remains taxable according to the laws of the United States and the Netherlands respectively, with due regard to the other provisions of the Convention. Thus, for example, if the

excess amount would be treated as a distribution of profits, such amount could be taxed as a dividend rather than as interest, but the tax would be subject to the rate limitations of paragraph 2 of Article 10 (Dividends).

Paragraph 6 limits the right of one State to impose tax on interest payments made by a resident of the other. The paragraph provides for the imposition of tax under those circumstances only with respect to (1) interest paid to a resident of the first-mentioned State, (2) interest attributable to a permanent establishment or a fixed base located in that first-mentioned state, or (3) interest that arises in the first-mentioned State and is not paid to a resident of the other State. Thus, if a Netherlands company derives income from the United States that is subject to the United States branch profits tax, even if the company has no permanent establishment in the United States (e.g., because such company makes an election to be taxed on a net basis under section 882(d) of the Code or such company disposes of a United States Real Property Interest), such interest is treated, by virtue of paragraph 4, as arising in the United States, and the United States retains the right to tax interest payments made by such company. Interest paid by a U.S. permanent establishment of a Netherlands company to a resident of the Netherlands, however, is not subject to U.S. tax by virtue of the source country exemption in paragraph 1 of Article 12.

Paragraph 6 also provides that the excess of the amount of interest deductible in one State by a company resident in the other that is subject to the branch tax in the first-mentioned State, over the interest actually paid by such permanent establishment or paid in connection with other income subject to the branch tax, shall be treated as interest derived and beneficially owned by a resident of that other State. Thus, the Article 12 exemption from source country taxation will generally prevent the United States from collecting the excess interest tax imposed by section 884(f) of the Code on a Netherlands resident.

Although paragraph 2 includes an excess inclusion with respect to a residual interest in a U.S. real estate mortgage investment conduit (REMIC) within the definition of interest, paragraph 7 provides that the exemption at source for interest provided for in paragraph 1 does not apply to such income. This class of income is subject to the statutory 30 percent U.S. rate of tax at source. The legislation that created REMICs in 1986 provided that such excess inclusions were to be taxed at the full 30 percent statutory rate, regardless of any then-existing treaty provisions to the contrary. Providing for the 30 percent rate in the Convention, therefore, conforms the treatment of excess inclusions with respect to residents of the Netherlands to Congressional intent.

Article 1 of the Protocol added a new paragraph 8 to the Article to deal with the treatment of interest in the context of

the so-called "triangular case." The inclusion of such a rule was provided for in paragraph 4 of Article 24 of the Convention prior to the Protocol.

The term "the triangular case" refers to the use of the following structure by a resident of the Netherlands to earn, in this case, interest income from the United States. The resident of the Netherlands, who is assumed to qualify for benefits under one or more of the provisions of Article 26 (Limitation on Benefits), sets up a permanent establishment in a third jurisdiction that imposes only a low rate of tax on the income of the permanent establishment. The Netherlands resident lends funds into the United States through the permanent establishment. The permanent establishment, despite its third-jurisdiction location, is an integral part of a Dutch resident. Therefore the income that it earns on those loans, absent the provisions of paragraph 8, is entitled to exemption from U.S. withholding tax under the Convention. Under current Netherlands law, under a Netherlands income tax treaty with the host jurisdiction of the permanent establishment, or in the case of the Netherlands Antilles or Aruba, under Netherlands Kingdom law, the income of the permanent establishment is exempt from Netherlands tax. Thus, the interest income is exempt from U.S. tax, is subject to little tax in the host jurisdiction of the permanent establishment, and is exempt from Netherlands tax. Although the paragraph is drafted reciprocally, as a practical matter, it will apply only with respect to U.S. source interest that is attributable to a third-jurisdiction permanent establishment of a Dutch resident, because the United States does not exempt the profits of a third-jurisdiction permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty. The descriptions in this explanation, therefore, are in the context of a resident of the Netherlands deriving U.S. source income.

It was mutually recognized by the two States that the multiple non-taxation resulting from this structure is an abuse that must be corrected. Proposed Netherlands legislation to correct the problem could not be enacted prior to ratification of the Convention, and, in any event, the proposed legislation would not deal with the issue with respect to Netherlands tax treaties or Kingdom legislation. When the legislation is enacted, and Dutch treaties and Kingdom legislation are amended to remove the exemption in abuse cases, the provision of paragraph 8 will be applicable less frequently.

Paragraph 8 replaces the U.S. source exemption for interest provided by paragraph 1 with a 15 percent U.S. withholding tax under the following circumstances. First, the profits of the permanent establishment arising from the U.S. source interest are subject to a combined effective rate of tax in the host jurisdiction of the permanent establishment and the Netherlands that is less than a specified threshold. That threshold is 50 percent of

the generally applicable rate of company tax in the Netherlands (i.e., 17.5 percent under present Netherlands law) for interest arising in the United States prior to January 1, 1998 and beneficially owned by a Netherlands resident. For interest arising after that date, the threshold rises to 60 percent (i.e., 21 percent under present Netherlands law).

In determining the aggregate rate of taxation to which the profits of the permanent establishment are subject it is necessary to add together any Netherlands tax paid on the profits and the taxes paid in the third jurisdiction. In general, the principles employed under Code section 954(b)(4) will be employed to determine whether the profits are subject to an effective rate of taxation that is above the specified threshold.

Notwithstanding the level of tax on the profits of the permanent establishment, however, the source exemption will continue to be granted if the income is derived in connection with or is incidental to an active trade or business carried on in the third jurisdiction by the permanent establishment. The business of making or managing investments is not considered to be an active trade or business, unless these are banking or insurance activities carried on by a bank or insurance company. Paragraph III. of the Agreed Minutes to the Protocol makes clear that the business of making or managing investments includes group financing or making portfolio investments. As a result, only banks or insurance companies could obtain the benefits of the active trade or business exception with respect to income derived from related party financing or portfolio investment.

Under the income tax convention between the Netherlands and Switzerland a specified percentage (usually 10 percent) of the income of a Swiss permanent establishment of a Netherlands resident will be allocated to and included in the taxable income of the Netherlands resident. The remainder of the income will be exempt from tax in the Netherlands. Income allocated to the Dutch taxing jurisdiction pursuant to the Netherlands-Switzerland treaty (or otherwise) is not considered to be "attributable" to the Netherlands (rather than the permanent establishment) for purposes of paragraph 8. Rather, the U.S. withholding tax imposed under paragraph 8 applies to the entire amount of the interest paid to the third-jurisdiction permanent establishment.

Therefore, if a Swiss permanent establishment of a Dutch resident lends funds of the resident to related parties in the United States, the U.S. source interest generated by those loans will be subject to a U.S. withholding tax of 15 percent, instead of the exemption provided in paragraph 1, if the Dutch tax and the Swiss tax results in an effective rate less than the threshold specified for the taxable year in question. If, on the other hand, the permanent establishment is engaged in, say, a manufacturing operation in Switzerland, and places some of its working capital

temporarily in the bonds of a related U.S. company, the interest on those bonds would continue to be exempt from U.S. tax because the income would be incidental to the active business in Switzerland of the permanent establishment. If, regardless of the nature of the activity of the permanent establishment, the host jurisdiction of the permanent establishment imposes an effective tax rate in excess of, say, 25 percent, the interest would be exempt from tax in the United States.

Notwithstanding the limitations on source country taxation of interest contained in this Article, the saving clause of paragraph 1 of Article 24 (Basis of Taxation) permits the United States to tax interest received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation), as if the Convention had not come into effect.

As with any benefit of the Convention, a resident of one of the States claiming the benefit of this Article must be entitled to the benefit under the provisions of Article 26 (Limitation on Benefits).

Article 13 - ROYALTIES

Article 13 provides rules for source and residence country taxation of royalties.

Paragraph 1 grants to the residence State the exclusive right to tax royalties arising in the other State, and derived and beneficially owned by a resident of the first-mentioned State. Thus, the exemption at source for royalties in the prior Convention is carried forward to the Convention.

Paragraph 2 generally follows the U.S. Model and defines the term "royalties" for purposes of the Convention to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work; for the use of, or the right to use, any patent, trademark, trade name, brand name, design or model, plan, secret formula or process; or for information concerning industrial, commercial, or scientific experience. The term also includes gains derived from the alienation of any such right or property that are contingent on the productivity, use, or further alienation thereof. Payments received in connection with the use or right to use cinematographic films, or works on film, tape, or other means of reproduction used for radio or television broadcasting are specifically excluded from the definition of royalties. Such payments are covered by the provisions of Article 7 (Business Profits). The reference to "other means of reproduction" makes clear that future technological advances in the field of radio and television broadcasting will not affect the exclusion of payments relating to the use of such means

of reproduction from the definition of royalties.

Paragraph 3 of Article 13 provides an exception to the source country exemption for royalties in cases where the beneficial owner of the royalties carries on business through a permanent establishment in the source state or performs independent personal services from a fixed base situated in the source state and the royalties are attributable to the permanent establishment or fixed base. In such cases the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services) will apply, and the source state will generally retain the right to tax such royalties on a net basis.

The rule in paragraph 3 of Article 24 (Basis of Taxation) dealing with deferred income and expenses of a permanent establishment or fixed base applies to paragraph 3 of this Article. Thus, royalty income that is attributable to a permanent establishment or fixed base, but is deferred until after the permanent establishment or fixed base no longer exists, may nevertheless be taxed by the State in which the permanent establishment or fixed base was located.

Paragraph 4 deals with cases involving special relationships between the payor and beneficial owner of a royalty. Paragraph 4 provides that the provisions of Article 13 apply to royalty payments between related persons only to the extent that such payments would have been made absent such special relationships (i.e., an arm's length royalty payment). Any amount in excess of an arm's length payment remains taxable according to the laws of the source State, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of profits under the national law of the source State, such excess amount will be taxed as a dividend rather than as a royalty payment, but the tax imposed on the dividend payment will be subject to the rate limitations of paragraph 2 of Article 10 (Dividends).

Paragraph 5 is not found in the U.S. or OECD Models. It limits the extent to which one State may tax royalties paid by a resident of the other State. Subparagraphs (a) and (b) of paragraph 5 permit taxation of such royalties when they are paid to a resident of the first-mentioned State (subparagraph (a)), or when they are attributable to a permanent establishment of fixed base situated in that first-mentioned State (subparagraph (b)). Even without these two subparagraphs these taxing rights could be exercised under the Convention by the State of residence or the State in which the permanent establishment or fixed base is located, under paragraph 1 of Article 24 (Basis of Taxation), Article 7 (Business Profits) or Article 15 (Independent Personal Services).

Subparagraphs (c) and (d) deal with taxation by one State of

a royalty paid by a resident of the other State to a resident of a third State for the use of an intangible in the first-mentioned State. Subparagraph (c) provides that if a royalty is borne by a permanent establishment or fixed base located in one of the States, and the contract in connection with which the royalty was paid was concluded in connection with that permanent establishment or fixed base, the State where the permanent establishment or fixed base is located may tax the royalty if it is not paid to a resident of the other State. The rate of the tax imposed on the royalty may be limited by reference to the tax treaty, if any, in force between the taxing State and the third State. Thus, for example, if a new process is developed by a Canadian company and licensed for use in the United States by a U.S. permanent establishment of a Dutch company, assuming that the royalties are paid by the branch, and deducted by it for U.S. tax purposes, then under U.S. law the Netherlands resident (i.e., the U.S. permanent establishment) is required to withhold U.S. tax on the royalty payment at a 10 percent rate, the rate applicable to royalties under the U.S.-Canada treaty. This result would also obtain absent the explicit statement in subparagraph 5(c) because the royalty is U.S. source under U.S. law, and it is not covered by the exemption in paragraph 1 of Article 13 since it would not be beneficially owned by a Netherlands resident.

Subparagraph (d) provides an additional case in which a State may tax royalties paid by a resident of the other to a third-country resident. Under Code section 861(a)(4), and, implicitly, under the U.S. Model, any royalty paid for the use of an intangible in the United States, regardless of the residence of the payor, is U.S. source, which, subject to any limitations in the tax treaty between the United States and the country of residence of the beneficial owner, may be taxed by the United States. Under the Convention, however, in addition to the circumstances described in subparagraph (c), one State may tax a royalty paid by a resident of the other State only if: (1) it is for the use of a property in the first-mentioned State, (2) it is not paid to a resident of that other State, (3) the payor of the royalty has also received a royalty in respect of the use of that same property in the first-mentioned State, and that royalty is either paid by a resident of that first-mentioned State or borne by a permanent establishment or fixed base situated in that State, and (4) the use of the intangible is not a component part of or directly related to the active conduct of a trade or business in which the payor (i.e., the resident of the other State) is engaged. The phrases "component part of" or "directly related to the active conduct of a trade or business" are to be understood in the same manner as those phrases are understood in paragraph 2 of Article 26 (Limitation on Benefits). For example, a Canadian resident licenses a patent for a process used in the automotive industry to a resident of the Netherlands, who is not engaged in the automotive industry, and the Netherlands resident sub-licenses the patent to an automobile producer in the United States. The U.S. producer pays a royalty to

the resident of the Netherlands for the use of the patent in the United States, and the Netherlands resident, in turn, pays a royalty to the Canadian resident for that same U.S. use of the patent. The royalty paid by the U.S. producer to the Netherlands resident would be exempt from U.S. tax under the provisions of paragraph 1 of Article 13. The royalty paid by the Netherlands resident to the resident of Canada, however, would be subject to U.S. tax under subparagraph (d). The rate would be set at 10 percent, under the provisions of the U.S.-Canada treaty. If, on the other hand, the Netherlands resident was also engaged in automobile production, the royalty paid by the Netherlands resident to the Canadian resident would not be subject to U.S. taxation.

Article 2 of the Protocol added a new paragraph 6 to the Article to deal with the treatment of royalties in the context of the so-called "triangular case." The inclusion of such a rule was provided for in paragraph 4 of Article 24 of the Convention prior to the Protocol. The rule in this paragraph is closely analogous to that found in paragraph 8 of Article 12 (Interest), which also was added by the Protocol. The principal difference between this paragraph and paragraph 8 of Article 12 is that this paragraph deals with U.S. source royalties that are attributable to a permanent establishment of a resident of the Netherlands located in a third jurisdiction.

Paragraph 6 replaces the U.S. source exemption for royalties provided by paragraph 1 with a 15 percent rate of U.S. tax at source on the gross royalty payment under the following circumstances. First, the profits of the permanent establishment are subject to a combined effective rate of tax in the host jurisdiction of the permanent establishment and the Netherlands that is less than a specified threshold. That threshold is 50 percent of the generally applicable rate of company tax in the Netherlands (i.e., 17.5 percent under present Netherlands law) for royalties arising in the United States prior to January 1, 1998 and beneficially owned by a Netherlands resident. For royalties arising after that date, the threshold rises to 60 percent (i.e., 21 percent under present Netherlands law).

Notwithstanding the level of tax on the profits of the permanent establishment, however, the source exemption will continue to be granted if the royalty is derived from the licensing of an intangible that has been developed in the third jurisdiction by the permanent establishment. Thus, if an Antilles permanent establishment of a Dutch resident develops a patent that is licensed to a resident of the United States, the royalties paid to the permanent establishment by the U.S. licensee in respect of that patent would continue to be exempt from U.S. tax at source under the provisions of paragraph 1. If, however, the permanent establishment is merely sub-licensing patents that have been developed elsewhere, the 15 percent U.S. tax at source provided for by paragraph 6 will apply, unless the combination of Antilles and

Netherlands tax on the profits of the permanent establishment exceeds the 50 or 60 percent threshold, as appropriate, provided for in paragraph 6. The determination of the effective rate of tax borne by the permanent establishment is made as described under paragraph 8 of Article 12.

Notwithstanding the limitations on source country taxation of royalties contained in this Article, the saving clause of paragraph 1 of Article 24 (Basis of Taxation) permits the United States to tax royalties received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation), as if the Convention had not come into effect.

As with any benefit of the Convention, a resident of one of the States claiming the benefit of this Article must be entitled to the benefit under the provisions of Article 26 (Limitation on Benefits).

ARTICLE 14 - CAPITAL GAINS

Article 14 provides rules for source and residence country taxation of gains from the alienation of property.

Paragraph 1 of Article 14 preserves the situs country right to tax gains derived from the alienation of real property situated in the situs state (the "source State"). Thus, paragraph 1 permits gains derived by a resident of one State from the alienation of real property located in the other State to be taxed by such other State.

For this purpose, the term "real property situated in the other State" includes real property referred to in Article 6 (Income from Real Property) (i.e., interests in the real property itself) and certain indirect interests in such property. Such indirect interests include shares or other comparable interests in a company that is (or is treated as) a resident of the source State, the assets of which company consist or consisted wholly or principally of real property situated in the source State. Companies treated as residents of the source State include non-U.S. corporations that have elected under section 897(i) of the Code to be treated as U.S. corporations. In addition, interests in a partnership, trust, or estate, to the extent that the assets of such entity consist of real property situated in the source State, are included in this definition. Finally, paragraph 1 provides that in all events the term "real property situated in the other State" includes a United States real property interest in the United States, as that term is defined in the Internal Revenue Code on the date of signature of the Convention, and as amended (without changing the general principles of paragraph 1). Thus, the United States preserves its right to collect the tax imposed by section

897 of the Code on gains derived by foreign persons from the disposition of United States real property interests, including gains arising from indirect dispositions described in section 897(h). For this purpose, the source rules of section 861(a)(5) of the Code shall determine whether a United States real property interest is situated in the United States.

Paragraph VII. of the Memorandum of Understanding provides that in determining whether the stock of a corporation resident in the United States is a "United States real property interest," the United States will take into account the fair market value of all assets of the corporation, including intangible assets. It is intended that this provision will be interpreted consistently with Treasury Regulation sections 1.897-2(b)(1) and 1.897-1(f)(1)(ii), and include all business assets, including intangible property (whether or not appearing as an asset on the balance sheet for tax purposes), in the analysis of whether the stock of a corporation is a United States real property interest.

The definition of "real property situated in the other State" applies solely for purposes of Article 14. Therefore, this definition has no effect on the right to tax income covered in other articles of the Convention.

Paragraph 2 provides a transitional rule reflecting the fact that Article XI of the prior Convention exempted certain gains from the sale or exchange of capital assets from taxation in the source State, provided the taxpayer had no permanent establishment in that State. Paragraph 2 applies to deemed, as well as actual, alienations or dispositions. Paragraph 2 applies exclusively to certain gains described in paragraph 1. Paragraph 1 will apply to transactions notwithstanding section 1125(c) of the Foreign Investment in Real Property Tax Act, Public Law 96-499 ("FIRPTA"), which generally provided that, in the case of persons entitled to the benefits of income tax treaties that exempted gains from the disposition of real property interests from U.S. tax, such persons would be subject to the provisions of section 897 with respect to their gains from the disposition of United States real property interests after January 1, 1985.

This provision represents a departure from U.S. tax treaty policy. Most recent treaties do not contain such a provision. One exception is the convention between the United States and Canada. This provision, however, is significantly more limited than its Canadian counterpart in that the provision in the Convention applies only to gains attributable to dispositions of stock and does not apply to gains attributable to direct holdings of real property. The Canadian provision applied to both direct and indirect holdings. Furthermore, the Canadian provision effectively exempted Canadian investors from tax on gains accruing up to the effective date of that convention. Paragraph 2 of Article 14, however, only would apply to gains accruing prior to 1985, and

permits full U.S. tax on gains arising after 1985.

If paragraph 2 applies to the alienation of an item of real property, the gain otherwise subject to tax in the situs State will be reduced by the amount of the gain attributable to the period during which the property was held up to and including December 31, 1984. The gain attributable to such period is normally determined by dividing the total gain by the number of full calendar months the property was held by the alienator, including, in the case of an alienation described in subparagraph 2(a)(ii), the number of months in which a predecessor in interest held the property, and multiplying such monthly amount by the number of full calendar months ending on or before December 31, 1984 during which the property was held. The following example illustrates the operation of this rule.

Example. A is an individual who has been a resident of the Netherlands since June 18, 1980. A acquired stock in a USRPHC on January 1, 1970. On December 31, 1996, A sells the stock of the USRPHC. A's gain on the sale is $500. In the absence of paragraph 2, the full amount of the gain would be taxable to A under section 897 of the Code. Pursuant to paragraph 2, the amount of the gain that is taxable to A is reduced by $269.23, i.e., the number of months during which the stock was held (312), divided by the gain realized ($500), multiplied by the number of months prior to December 31, 1984 during which A held the stock (168).

Upon a clear showing, however, a taxpayer may prove that a greater portion of the gain was attributable to the specified period. Thus, in the United States the fair market value of the alienated property at December 31, 1984 may be established under paragraph 2 in the manner and with the evidence that is generally required by U.S. Federal income, estate, and gift tax regulations. For this purpose a taxpayer may use valid appraisal techniques for valuing real estate such as the comparable sales approach (see Rev. Proc. 79-24, 1979-1 C.B. 565) and the reproduction cost approach. If more than one property is alienated in a single transaction each property will be considered individually.

A taxpayer who desired to make this alternate showing for U.S tax purposes must so indicate on his U.S. income tax return for the year of the sale or exchange and must attach to the return a statement describing the relevant evidence. The U.S. competent authority or his authorized delegate will determine whether the taxpayer has satisfied the requirements of paragraph 2.

The amount of gain that is reduced by reason of the application of paragraph 2 is not to be treated for U.S. tax purposes as an amount of "nontaxed gain" under section 1125(d(2)(B) of FIRPTA, where that section otherwise would apply. (Note that gain not taxed by virtue of the prior Convention is "nontaxed gain.")

Paragraph 2 applies to gains realized from the disposition of real property situated in the other State (as defined in paragraph 1) if the gain could not be taxed by the other State under the provisions of the prior Convention. Under Article XI of the prior Convention, sales of capital assets, including shares of stock, generally could not be taxed in the other State. Article XI did not apply, however, to gains from the disposition of direct holdings of real property. Rather, Article V of the prior Convention permitted situs State taxation of gains arising from the disposition of direct holdings of real property. Therefore, paragraph 2 applies only to dispositions of stock in companies that are described in subparagraph (b) of paragraph 1. Thus, paragraph 2 applies to dispositions of stock in United States Real Property Holding Companies, but not to dispositions of direct holdings in real property.

When a person who has continuously been a resident of one of the States since June 18, 1980 alienates real property that is described in paragraph 2, the gain subject to tax in the other State may be reduced if the resident either (i) owned the alienated property continuously from June 18, 1980 until the date of alienation, or (ii) acquired the property in a transaction qualifying as a non-recognition transaction in the other State, and the resident has owned the property continuously since the acquisition, and the resident's initial basis in the alienated property is equal either to the basis of the property that the resident exchanged for the alienated property, or to the basis of the acquired property in the hands of the person transferring the property to the resident. For this purpose, a transaction qualifying for non-recognition is a transaction in which gain resulting therefrom is effectively deferred for tax purposes, but is not permanently forgiven. Thus, in the United States, certain tax-free organizations, reorganizations, liquidations and like-kind exchanges will qualify as non-recognition transactions. However, a transfer of United States real property at death would not constitute a non-recognition transaction for purposes of paragraph 2, as the recipient of the property will acquire the property with a basis equal to the property's fair market value as of death. Only transaction in which the property has a basis in the hands of the recipient that is a carryover or substituted basis will qualify as a non-recognition transaction for purposes of paragraph 2. If a transaction is a non-recognition transaction for tax purposes, the transfer of non-qualified property, or "boot," which may cause some portion of the gain on the transaction to be recognized, will not cause the transaction to lose its character as a non-recognition transaction for purposes of paragraph 2. In addition, a transaction that would have been a non-recognition transaction in the United States but for the application of section 897(d) and 897(e) of the Code also will constitute a non-recognition transaction for purposes of paragraph 2. Further, a transaction that is not a non-recognition transaction under United States law, but to which non-recognition treatment is granted pursuant to the

agreement of the competent authority under paragraph 8 of this Article, is a non-recognition transaction for purposes of paragraph 2. However, a transaction that is not a non-recognition transaction under United States law does not become a non-recognition transaction for purposes of paragraph 2 merely because the basis of the property in the hands of the transferee is reduced under section 1125(d) of FIRPTA.

Paragraph 2 is subject to several further restrictions. Subparagraph (b) provides that paragraph 2 will not apply unless the resident and any other person that owned the property during the period from January 1, 1992 through the date of alienation, was entitled to the benefits of Article 14 under Article 26 (Limitation on Benefits) or would have been so entitled had the Convention been in effect. Each person that owned the property during this period must have been so qualified throughout the portion of that period in which it owned the property. Further, during the period from June 18, 1980 through December 31, 1991, each person who owned the property must have been a resident of one of the States under the prior Convention. Each person that owned the property during this period must have been such a resident throughout the portion of that period in which it owned the property. Thus, for example, in order for paragraph 2 to be available to a Netherlands resident who did not own the asset on June 18, 1980, the asset must have been owned by residents of either State continuously since June 18, 1980 and must have been transferred only in transactions that were non-recognition transaction for United States tax purposes.

Finally, subparagraph (c) provides that paragraph 2 will not apply to certain alienations of property. Subparagraph (c)(i) provides that paragraph 2 does not apply to alienations of property forming part of the property of a permanent establishment or pertaining to a fixed base situated in the other States at any time on or after June 18, 1980. Subparagraph (c)(ii) provides that paragraph 2 does not apply to alienations of property that was acquired directly or indirectly by any person on or after June 18, 1980 in a transaction that did not qualify for non-recognition, or in a transaction in which it was acquired in exchange for an asset that did not qualify for non-recognition. This subparagraph clarifies the requirements under subparagraph (a)(ii). Finally, subparagraph (c)(iii) provides that paragraph 2 does not apply to alienations of property that was acquired directly or indirectly by any person on or after June 18, 1980 in exchange for property described in subparagraphs (c)(i) or (c)(ii), or for property the alienation of which could have been taxed by the other State under the provisions of the prior Convention.

The following examples illustrate the application of paragraph 2. The examples do not, however, fully describe the United States and Netherlands tax consequences resulting from the described transactions. Any condition for the application of paragraph 2 that is not discussed in an example is assumed to be satisfied.

Example 1. A, an individual resident of the Netherlands, owned stock in a United States Real Property Holding Corporation ("USRPHC") on June 18, 1980. On January 1, 1982, A transferred the stock to X, a Netherlands corporation, in exchange for 100 percent of the stock of X, a transaction qualifying as a reorganization under section 368(a)(1)(B) of the Code. A's gain on the transaction was exempt from United States tax under Article XI of the prior Convention. Since the transaction qualifies as a non-recognition transaction for United States tax purposes, in accordance with subparagraph 2(a)(ii) X is entitled to the benefits of paragraph 2 on a subsequent disposition of the stock of the USRPHC occurring after the entry into force of the Convention. Alternatively, if A had transferred the stock to X after the entry into force of the Convention, A would be entitled to the benefits of paragraph 2, pursuant to subparagraph 2(a)(ii), on a subsequent disposition of the stock.

Example 2. The facts are the same as in Example 1, except that A is a corporation resident in the Netherlands. The results are the same as in Example 1. If, however, A disposes of the stock after January 1, 1992, and under Article 26 (Limitation on Benefits), A would not qualify for the benefits of Article 14, paragraph 2 will not apply by reason of subparagraph 2(b).

Example 3. The facts are the same as in Example 1, except that A transfers an apartment building located in the United States rather than stock in a USRPHC. Because the prior Convention would not have exempted the gain on such transaction from United States tax, paragraph 2 is inapplicable.

Example 4. The facts are the same as in Example 1, except that X is a U.S. corporation. If the transfer by A to X occurred on January 1, 1982, A's gain on the transaction would have been exempt from U.S. tax under Article XI of the prior Convention. Consequently, A would be entitled to the benefits of paragraph 2, pursuant to subparagraph 2(a)(ii), on a subsequent disposition of the stock of X occurring after the entry into force of the Convention. If the transfer from A to X occurred after the entry into force of the Convention, A would be entitled to the benefits of paragraph 2, pursuant to subparagraph 2(a)(i), with respect to any U.S. taxation of the gain resulting from the transfer to X, because A would have held the property continuously during the period from June 18, 1980 through the date of alienation. A also would be entitled to the benefits of subparagraph 2, pursuant to subparagraph 2(a)(ii), on a subsequent disposition of the stock of X. Paragraph 2 would not apply, however, to a disposition by X of the USRPHC stock.

Example 5. B, a corporation resident in the Netherlands, owns all the stock of C, which also is a corporation resident in the Netherlands. C owns stock in a USRPHC. Both B and C would qualify for the benefits of Article 14 under Article 26 (Limitation on

Benefits). After the entry into force of the Convention, B liquidates C pursuant to a liquidation under section 332 of the Code. The transaction is treated as a non-recognition transaction for U.S. tax purposes. C is entitled to the benefits of paragraph 2, pursuant to subparagraph 2(a)(i), with respect to any gain taxed under section 897(d) of the Code, and B is entitled to the benefits of paragraph 2, pursuant to subparagraph (2)(a)(ii), on a subsequent disposition of the USRPHC stock.

Example 6. The facts are the same as in Example 5, except that C is a U.S. corporation. B is entitled to the benefits of paragraph 2, pursuant to subparagraph 2(a)(i), with respect to any gain taxed as a result of the liquidation of C. B also is entitled to the benefits of paragraph 2, pursuant to subparagraph 2(a)(ii), on a subsequent disposition of the stock of the USRPHC. The U.S. tax consequences to C are governed by the internal law of the United States.

Example 7. A and B are corporations resident in the Netherlands. Both A and B would qualify for the benefits of Article 14 under Article 26 (Limitation on Benefits). A owns stock in a USRPHC that it acquired prior to June 18, 1980. B owns an apartment building in the United States that it acquired prior to June 18, 1980. After the entry into force of the Convention, A exchanges the stock in the USRPHC for the apartment building pursuant to a taxable exchange. A is entitled to the benefits of paragraph 2, pursuant to subparagraph 2(a)(i), because it has held the stock of the USRPHC continuously since June 18, 1980, with respect to any gain realized on the exchange. By reason of subparagraph 2(c)(iii), A is not entitled to the benefits of paragraph 2 on a subsequent sale of the stock of the USRPHC, because the stock was not acquired in a non-recognition transaction.

Example 8. The facts are the same as in Example 7, except that B contributes the apartment building to the USRPHC in exchange for 80 percent of the stock of the USRPHC in a transaction described in section 351 of the Code. B is not entitled to the benefits of paragraph 2, because United States tax on the gain arising from a disposition of the building was not prohibited by the prior Convention. In addition, pursuant to subparagraph 2(c)(iii), paragraph 2 also does not apply to a subsequent disposition of the USRPHC stock by B, because the USRPHC stock was acquired in exchange for property (the apartment building) the alienation of which could have been taxed by the United States under the prior Convention.

Paragraph 3 of Article 14 preserves the source country right to tax gains from the alienation of certain types of personal property. Paragraph 3 provides that gains from the alienation of personal property forming part of the business property of a permanent establishment that an enterprise of a State has in the

other State or of personal property pertaining to a fixed base available to a resident of a State for the purpose of performing independent personal services, including such gains from the alienation of such permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in the other State. This provision permits gains from the alienation by a resident of a State of an interest in a partnership, trust or estate that has a permanent establishment situated in the other State to be taxed as gains attributable to such permanent establishment under paragraph 3. Thus, for example, the United States may tax gains derived from the disposition of an interest in a partnership that has a permanent establishment in the United States, regardless of whether the assets of such partnership consist of personal property as defined in Article 14.

Paragraph 4 contains an exception from the rule set forth in paragraph 3. This exception relates to deemed alienations of tangible depreciable personal property forming part of the business property of a permanent establishment that an enterprise of one of the States has in the other State or of tangible depreciable personal property pertaining to a fixed base available to a resident of one of the States in the other State for the purpose of performing personal services, if such permanent establishment or fixed base is described under paragraph 3 of Article 27 (Offshore Activities). This paragraph limits the scope of Netherlands domestic law, which generally provides for tax on any appreciation in the value of equipment employed by a permanent establishment in the Netherlands between the date that the equipment is introduced into the Netherlands and the date it is removed. Paragraph 4 provides that, notwithstanding paragraph 3 of Article 14, such gains are taxable only in the State of residence of the enterprise if the period during which the tangible depreciable personal property forms part of the business property of such permanent establishment or pertains to such fixed base is less than 3 months and provided that the actual alienation of the tangible personal property does not take place within 1 year after the date of its deemed alienation. Furthermore, in cases in which such gain is taxable only in the State of residence of the enterprise, the depreciable basis of the property will be based on the lower of book value or fair market value as of the date that the property became part of the business property of the permanent establishment or first pertained to the fixed base for purposes of determining the profits of the permanent establishment or fixed base in the other State.

Paragraph 5 of Article 14 provides a further exception from the rule set forth in paragraph 3. Paragraph 5 provides that profits derived from alienating ships and aircraft operated in international traffic and from personal property such as containers pertaining to such operations of such ships and aircraft are taxable only in the State in which the enterprise is resident.

Paragraph 6 of Article 14 provides that gains described in Article 13 (Royalties) shall be taxable in accordance with the provisions of Article 13. This paragraph applies to gains derived from the alienation of rights to intangible property if the amount of the gain is contingent on the productivity, use of disposition thereof, which are described in paragraph 2 of Article 13. Treatment of gains attributable to intangible property that are not described in paragraph 2 of Article 13 is governed by paragraph 7 of Article 14.

Subject to the special rules of paragraphs 8 and 9, paragraph 7 of Article 14 grants to the residence State the exclusive right to tax gains from the alienation of property other than those specifically referred to in the preceding paragraphs of Article 14.

Paragraph 8 of Article 14 provides rules for coordination of Netherlands and United States rules with respect to the recognition of gain on corporate organizations, reorganizations, amalgamations or similar transactions. Where a resident of one of the States alienates property in such a transaction, and gain or income with respect to such alienation is not recognized or is deferred for purposes of taxation in that State, then the alienator may request the competent authority of the other State to agree to defer any tax arising from such transaction to the same extent that such tax would have been deferred if the alienator had been a resident of that other State. The provisions of this paragraph are inapplicable to defer recognition of corporate-level gain by liquidating corporations under Code section 367(e)(2) because the person recognizing the gain in such a transaction is the liquidating corporation, a U.S. resident. Furthermore, deferral under this paragraph may not exceed the period of time or amount of any deferral in the alienator's State of residence. In addition, the competent authorities of both States must be satisfied that any tax deferred under paragraph 8 can be collected upon a later alienation and that the collection of the tax is adequately secured. This provision means, for example, that the United States competent authority may agree to defer recognition of gain with respect to a transaction if the alienator, a resident of the Netherlands, would otherwise recognize gain for U.S. tax purposes, would not have recognized gain currently if the alienator had been a U.S. resident, and would not recognize gain under Netherlands law. Paragraph 8 contemplates that the competent authorities will develop procedures for implementation of paragraph 8.

Furthermore, paragraph VIII. of the Memorandum of Understanding provides that the relief provided under paragraph 8 of Article 14 shall not be available if the tax that otherwise would be imposed cannot be reasonably imposed or collected in the future. In order to ensure that any deferred United States tax may be collected in the future, the United States competent authority may require the alienator or shareholders of a corporation that is a party to the transaction to reduce the basis of any stock

received pursuant to the reorganization by closing agreement in order to ensure that the tax that otherwise would have been imposed may be collected at a later time. If such adjustments cannot be made, then the relief described in paragraph 8 will not be available.

Paragraph 9 of Article 14 provides an exception from the general exemption from source country tax contained in paragraph 7 for gains derived by certain individuals from the alienation of shares forming part of a 25 percent interest in a company resident in the source State. Under this rule, if an individual was a resident of a State and becomes a resident of the other State under the rules of Article 4 (Residence), and such individual derives gains from the disposition of all or part of a 25 percent interest in a company that is resident in the first-mentioned State, the first-mentioned State may tax such gain under its national law, provided the alienation giving rise to the gain occurs within 5 years of the date on which the individual ceased to be a resident of the first-mentioned State. For purposes of determining whether an individual controls at least 25 percent of any class of shares of a company, the alienator's shares are aggregated with any shares owned by "related individuals." Related individuals for this purpose means the alienator's spouse and relatives (by blood or marriage) in the direct line (ancestors and lineal descendants) and relatives (by whole or half blood or marriage) in the second degree in the collateral line (siblings or their spouses).

Notwithstanding the foregoing limitations on source country taxation of certain gains, the saving clause of paragraph 1 of Article 24 (Basis of Taxation) permits the United States to tax gains realized by its residents and citizens, subject to the special foreign tax credit rules of Article 25 (Methods of Elimination of Double Taxation), as if the Convention had not come into effect.

As with any benefit of this Convention, a resident of one of the States claiming the benefit of this Article must be entitled to the benefit under the provisions of Article 26 (Limitation on Benefits).

Article 15 - INDEPENDENT PERSONAL SERVICES

The Convention deals in separate articles with different classes of income from personal services. Article 15 deals with the general class of income from independent personal services and Article 16 deals with the general class of dependent personal service income. Exceptions or additions to these general rules are found in Articles 17 through 22 for directors' fees (Article 17); performance income of artistes and athletes (Article 18); pensions in respect of personal service income, social security benefits, annuities, and alimony (Article 19); government service salaries

and pensions (Article 20); the income of visiting professors and teachers (Article 21), and students and trainees (Article 22).

Article 15 provides the general rule that an individual who is a resident of a Contracting State and who derives income from the performance of personal services in an independent capacity will be exempt from tax in respect of that income by the other Contracting State unless certain conditions are satisfied. The income may be taxed in the other Contracting State if the services are not performed in the State of residence of the individual, and the income is attributable to a fixed base that is regularly available to the individual in that other State for the purpose of performing his services. If, however, the individual is a Netherlands resident who performs independent personal services in the United States, and he is also a U.S. citizen, the United States may, by virtue of the saving clause of paragraph 1 of Article 24 (Basis of Taxation), tax his income without regard to the restrictions of this Article, subject to the special foreign tax credit rules of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation).

This rule differs in one significant respect from that in the U.S. Model. Under the U.S. Model, a Contracting State only may tax income if it is both attributable to a fixed base in that State and is derived from services performed in that State. In the OECD Model, by contrast, income attributable to a fixed base, wherever performed, may be taxed by the State in which the fixed base is situated ("the host State"). The rule in the Convention represents a compromise between these two positions. A State may tax income from the performance of independent personal services by a resident of the other State if the income is attributable to a fixed base in the first State, unless the services are performed in the other State. Thus, if a U.S. resident derives income from the performance of independent personal services in Belgium, but that income is attributable to a fixed base regularly available to that individual in the Netherlands, the Netherlands may tax the income. If, however, income attributable to the fixed base in the Netherlands is derived from services performed in the United States, that income may not be taxed by the Netherlands. In the former case, the United States also may tax this income, but will grant a credit to the taxpayer pursuant to Article 25 ((Methods of Elimination of Double Taxation) for the Netherlands taxes paid.

The term "fixed base" is not defined in the Convention, but its meaning is understood to be analogous to that of the term "permanent establishment," as defined in Article 5 (Permanent Establishment). Similarly, some rules of Article 7 (Business Profits) for attributing income and expenses to a permanent establishment are relevant for attributing income to a fixed base. However, the taxing right conferred by this Article with respect to income from independent personal services is somewhat more limited than that provided in Article 7 for the taxation of business

profits. In both Articles 7 and 15 the income of a resident of one Contracting State must be attributable to a permanent establishment or fixed base in the other in order for that other State to have a taxing right. In Article 15, however, the income also must be attributable to services that are not performed in the individual's State of residence, while Article 7 is not concerned with the place of performance of the income-generating activities, so long as the income is attributable to the permanent establishment.

Paragraph 2 notes that the term "professional services" includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list is clearly not exhaustive. The term includes all personal services performed by an individual for his own account, whether as a sole proprietor or a partner, where he receives the income and bears the risk of loss arising from the services. Income from services in which capital is a material income producing factor will, however, generally be governed by the provisions of Article 7 (Business Profits). The taxation of income of an individual from independent services described in Articles 17 through 22 is governed by the provisions of those Articles rather than Article 15.

The rule in paragraph 3 of Article 24 (Basis of Taxation) dealing with deferred income and expenses of a permanent establishment or fixed base applies to paragraph 1 of this Article. Thus, income, gain or expense that is attributable to a fixed base, but is deferred until after the fixed base is no longer available to the performer of the services may nevertheless be taxed or deducted, as the case may be, by the State in which the fixed base was located. The rule in paragraph 3 of Article 24 dealing with gain from the alienation of property that had formed part of the business property of a permanent establishment or a fixed base also applies to paragraph 1 of Article 15. Thus, if an item of tangible personal property is used in connection with the derivation by an individual resident of one State of income attributable to a fixed base in the other, and that property is alienated after the property no longer forms part of the business property of the fixed base, but within three years of that time, the State in which the fixed base was located may tax the gain.

The taxing rule in paragraph 1 of the Article differs from that in the prior Convention. Under Article XVI of the prior Convention the host State could tax income from independent personal services performed by a resident of the other State only if the person performing the services was present in the host State for a period or periods aggregating more than 183 days in the taxable year.

Article 16 - DEPENDENT PERSONAL SERVICES

This Article deals with the taxation of remuneration derived by a resident of a Contracting State as an employee.

Under paragraph 1, remuneration in respect of employment derived by an individual who is a resident of a Contracting State generally may be taxed only by his State of residence. To the extent his remuneration is derived from an employment exercised in the other State ("the host State"), the remuneration may also be taxed by the host State, subject to the conditions specified in paragraph 2. In such a case the individual's State of residence will relieve double taxation in accordance with the provisions of Article 25 (Methods of Elimination of Double Taxation). Consistent with the general rule of construction that the more specific rule takes precedence over the more general, income dealt with in Articles 17 (Directors' Fees), 19 (Pensions, Annuities, Alimony), 20 (Government Service) and 21 (Professors and Teachers) is governed by the provisions of those articles rather than this Article.

Notwithstanding paragraph 1, paragraph 2 provides that the host State may not tax the remuneration of a resident of the other State (described in paragraph 1) derived from sources within the host State (i.e., the services are performed there), if three conditions are satisfied: (1) the individual is present in the host State for a period or periods not exceeding 183 days in the taxable year; (2) the remuneration is paid by, or on behalf of, an employer who is not a resident of the host State; and (3) the remuneration is not borne as a deductible expense by a permanent establishment or fixed base that the employer has in the host State. If a foreign employer pays the salary of an employee, but a host State corporation or permanent establishment reimburses the foreign employer in a deductible payment which can be identified as a reimbursement, neither condition (2) nor (3), as the case may be, will be considered to have been fulfilled. Conditions (2) and (3) are intended to assure that a State will not be required both to allow a deduction to the payor for the amount paid and to exempt the employee on the amount received. In order for the remuneration to be exempt from tax in the host State, all three conditions must be satisfied.

Paragraph 3 contains a special rule applicable to remuneration for services performed by an individual who is a resident of a State as an employee aboard a ship or aircraft operated in international traffic. Such remuneration may be taxed only in the State of residence of the employee if the services are performed as a member of the regular complement of the ship or aircraft. The "regular complement" includes the crew. In the case of a cruise ship, it may also include others, such as entertainers, lecturers, etc., employed by the shipping company to serve on the ship. The use of the term "regular complement" is intended to clarify that a

person who exercises his employment as, for example, an insurance salesman, while aboard a ship or aircraft is not covered by this paragraph.

The comparable provision in the OECD Model provides a different rule. Under paragraph 3 in the OECD Model such income may be taxed (on a non-exclusive basis) in the Contracting State in which the place of effective management of the employing enterprise is situated. The United States does not use this rule in its Model, because under U.S. law, a taxing right over an employee of an enterprise managed in the United States (or an employee of a U.S. resident) cannot be exercised with respect to non-U.S. source income unless the employee is also a U.S. citizen or resident.

If a U.S. citizen who is resident in the Netherlands performs dependent services in the United States and meets the conditions of paragraph 2, or is a crew member on a Dutch ship or airline, and would, therefore, be exempt from U.S. tax were he not a U.S. citizen, he is nevertheless taxable in the United States on his remuneration by virtue of the saving clause of paragraph 1 of the Article 24 (Basis of Taxation), subject to the special foreign tax credit rule of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation).

Article 17 - DIRECTORS' FEES

This Article provides that one of the States may tax the fees or other remuneration paid by a company which is a resident of that State for services performed by a resident of the other State in his capacity as a director, "bestuurder" or "commissaris" of the company. The latter two terms refer to positions in Netherlands corporations that are analogous to the position of director. For this purpose, "other remuneration" includes fixed salaries (or the portion thereof) paid for services performed as a director. Only the State of residence of the director, however, may tax any portion of the remuneration that is derived in respect of services performed in that State.

This rule is an exception to the more general rules of Article 15 (Independent Personal Services) and Article 16 (Dependent Personal Services). Thus, for example, in determining whether a non-employee director's fee is subject to tax in the country of residence of the corporation, whether the fee is attributable to a fixed base is not relevant.

The preferred U.S. policy is to treat a corporate director in the same manner as any other individual performing personal services -- outside directors would be subject to the provisions of Article 15 (Independent Personal Services) and inside directors would be subject to the provisions of Article 16 (Dependent Personal Services). The United States has also accepted provisions

in a number of treaties under which the State of residence of the corporation can tax the remuneration of a director who is a resident of the other State only to the extent that the remuneration is for services performed in that State. The preferred Netherlands position, on the other hand, is that reflected in the OECD Model, in which a resident of one Contracting State who is a director of a corporation which is resident in the other Contracting State is subject to tax in that other State in respect of his directors' fees regardless of where the services are performed. The provision in Article 17 of the Convention, therefore, represents a compromise between these two positions. The State of residence of the corporation may tax nonresident directors, with no threshold, but only with respect to remuneration for services that are not performed in the other State.

This Article is subject to the saving clause of paragraph 1 of the Article 24 (Basis of Taxation). Thus, if a U.S. citizen who is a Netherlands resident is a director of a U.S. corporation, the United States may tax his full remuneration regardless of the place of performance of his services, subject, however, to the special foreign tax credit provisions of paragraph 6 of Article 25 (Methods for Elimination of Double Taxation).

The prior Convention contains no special rule dealing with corporate directors. They are subject to the normal rules regarding the taxation of persons performing personal services.

Article 18 - ARTISTES AND ATHLETES

This Article deals with the taxation by one State of artistes (i.e., performing artists and entertainers) and athletes resident in the other State from the performance of their services as such. The Article applies both to the income of an entertainer or athlete who performs services on his own behalf and one who performs his services on behalf of another person, either as an employee of that person, or pursuant to any other arrangement. The rules of this Article take precedence over those of Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services). This Article applies, however, only with respect to the income of performing artists and athletes. Others involved in a performance or athletic event, such as producers, directors, technicians, managers, coaches, etc., remain subject to the provisions of Articles 15 and 16.

Paragraph 1 describes the circumstances in which one State may tax the performance income of an entertainer or athlete who is a resident of the other State. Income derived by a resident of one State from his personal activities as an entertainer or athlete exercised in the other State may be taxed in that other State if the amount of the gross receipts derived by the individual for the taxable year exceeds $10,000 (or its equivalent in Netherlands

guilders as of January 1 of that year). The $10,000 includes expenses reimbursed to the individual or borne on his behalf. If the gross receipts exceed $10,000, the full amount, not just the excess, may be taxed in the State of performance.

The OECD Model provides for taxation by the country of performance of the remuneration of entertainers or athletes with no dollar or time threshold. The United States introduces the dollar threshold test in its treaties to distinguish between two groups of entertainers and athletes -- those who are paid very large sums of money for very short periods of service, and who would, therefore, normally be exempt from host country tax under the standard personal services income rules, and those who earn only modest amounts and are, therefore, not clearly distinguishable from those who earn other types of personal service income.

Paragraph 1 applies notwithstanding the provisions of Articles 15 (Independent Personal Services) or 16 (Dependent Personal Services). Thus, if an individual would otherwise be exempt from tax under those Articles, but is subject to tax under this Article, he may be taxed in accordance with Article 18. An entertainer or athlete who receives less than the $10,000 threshold amount, and who is, therefore, not subject to tax under the provisions of this Article, may, nevertheless, be subject to tax in the host country under Articles 14 or 15 if the tests for taxability under those Articles are met. For example, if an entertainer who is an independent contractor earns only $9,500 of income for the calendar year, but the income is attributable to a fixed base regularly available to him in the State of performance (such as a cocktail lounge in which he regularly performs), that State may tax his income under Article 15.

Since it is frequently not possible to know until year end whether the income an entertainer or athlete derived from performance in a Contracting State will exceed $10,000, nothing in the Convention precludes that State from withholding tax during the year and refunding after the close of the year if the taxability threshold has not been met. If, at the end of the year, it is determined that the entertainer or athlete is not subject to host-country tax under the provisions of paragraph 1 of the Article, the exemption is effected by means of a refund of the tax withheld upon application after the end of the taxable year concerned. Paragraph 1 specifies that such application must be submitted within three years from the end of that year.

Income derived from one State by an entertainer or athlete who is a resident of the other in connection with his activities as such, but from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this Article, but by other articles of the Convention, as appropriate, such as Article 13 (Royalties) or Article 15 (Independent Personal Services). For example, if an entertainer

receives royalty income from the sale of recordings of a concert given in a State, the royalty income would be exempt from source country tax under Article 13, even if the remuneration from the concert itself may have been covered by this Article.

Paragraph 2 is intended to eliminate the potential for abuse when income from a performance by an entertainer or athlete does not accrue to the performer himself, but to another person. Foreign entertainers commonly perform in the United States as employees of, or under contract with, a company or other person. The relationship may truly be one of employee and employer, with no abuse of the tax system either intended or realized. On the other hand, the "employer" may, for example, be a company established and owned by the performer, which is merely acting as the nominal income recipient in respect of the remuneration for the entertainer's performance. The entertainer may be acting as an "employee", receiving a modest salary, and arranging to receive the remainder of the income from his performance in another form or at a later time. In such case, absent the provisions of paragraph 2, the company providing the entertainer's services could attempt to escape host country tax because it earns business profits but has no permanent establishment in that country. The entertainer may largely or entirely escape host country tax by receiving only a small salary in the year the services are performed, perhaps small enough to place him below the dollar threshold in paragraph 1. He would arrange to receive further payments in a later year, when he is not subject to host country tax, perhaps as salary payments, dividends or liquidating distributions.

Paragraph 2 seeks to prevent this type of abuse while at the same time protecting the taxpayer's right to the benefits of the Convention when there is a legitimate employee-employer relationship between the performer and the person providing his services. Under paragraph 2, when the income accrues to a person other than the performer, and the performer (or persons related to him) participate, directly or indirectly, in the profits of that other person, the income may be taxed in the Contracting State where the performer's services are exercised, without regard to the provisions of the Convention concerning business profits (Article 7) or independent personal services (Article 15). Thus, even if the "employer" has no permanent establishment or fixed base in the host country, its income may be subject to tax there under the provisions of paragraph 2. Taxation under paragraph 2 is imposed on the person providing the services of the entertainer or athlete. This paragraph does not affect the rules of paragraph 1, which apply to the entertainer or athlete himself. To the extent of salary payments to the performer, which are treated under paragraph 1, the income taxable by virtue of paragraph 2 to the person providing his services is reduced.

For purposes of paragraph 2, income is deemed to accrue to another person (i.e., the person providing the services of the

entertainer or athlete) if that other person has control over, or the right to receive, gross income in respect of the services of the entertainer or athlete. Direct or indirect participation in the profits of a person may include, but is not limited to, the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income or other income or distributions.

The paragraph 2 override of the protection of Articles 7 (Business Profits) and 15 (Independent Personal Services) does not apply if it is established that neither the entertainer or athlete, nor any persons related to the entertainer or athlete, participate directly or indirectly in the profits of the person providing the services of the entertainer or athlete. Thus, for example, assume that a circus owned by a U.S. corporation performs in Amsterdam, and the Netherlands promoters of the performance pay the circus, which, in turn, pays salaries to the clowns. The circus has no permanent establishment in the Netherlands. Since the clowns do not participate in the profits of the circus, but merely receive their salaries out of the circus' gross receipts, the circus is protected by Article 7 and its income is not subject to Netherlands tax. Whether the salaries of the clowns are subject to Netherlands tax depends on whether they exceed the $10,000 threshold in paragraph 1, and, if not, whether they are taxable under Article 16 (Dependent Personal Services).

This exception to the paragraph 2 override of the Articles 7 and 15 protection of persons providing the services of entertainers and athletes for non-abusive cases is not found in the OECD Model. The policy reflected in this exception is, however, consistent with the stated intent of Article 17 of the 1977 Model, as indicated in its Commentaries. The Commentaries to Article 17 of the 1977 OECD Model state that paragraph 2 is intended to counteract certain tax avoidance devices, in which income is diverted from the performer to another person in order to minimize the total tax on the remuneration. It is, therefore, consistent not to apply these rules in non-abusive cases.

This Article is subject to the provisions of the saving clause of paragraph 1 of a 24 (Basis of Taxation). Thus, if an entertainer or athlete who is resident in the Netherlands is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of this Article, subject, however, to the special foreign tax credit provisions of paragraph 6 of Article 25 (Methods of Elimination of Double Taxation).

The prior Convention contains no special rules for the taxation of the income of entertainers and athletes. Such income is subject to the general rules for the taxation of personal service income.

Article 19 - PENSIONS, ANNUITIES, ALIMONY

This Article deals with the taxation of private (i.e., non-government) pensions, annuities, social security, and similar benefits, and alimony payments.

Paragraph 1 provides that private pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment are generally taxable only in the State of residence of the recipient. The paragraph also provides for exclusive residence country taxation of annuities. Subject to special rules in paragraphs 2 and 3, this rule applies to all forms of payment. Treatment of such payments under the prior Convention is essentially the same as under the Convention, except that the rules of the prior Convention apply only to periodic payments. The rules of this paragraph do not apply to items of income which are dealt with in Article 20 (Government Service), including pensions in respect of government service, or to social security benefits, which are dealt with in paragraph 4 of Article 19.

The term "annuity" as used in this Article is defined in paragraph 5 to mean a stated sum paid periodically at stated times during life or during a specified or ascertainable period of time under an obligation to make the payment in return for adequate and full consideration in money or money's worth. Annuities are similarly defined under the prior Convention.

Under paragraph 2, if an individual who is a resident of one of the States receives a payment of the type referred to in paragraph 1 in respect of employment exercised in the other State, and the payment is not periodic, or is a lump-sum payment in lieu of an annuity, and the individual was a resident of that other State at any time during the five-year period preceding the date of the payment, that other State may also tax the payment. This is not the grant of an exclusive taxing right. Thus, for example, if an individual who has been a resident of the Netherlands, and who worked in the Netherlands, retires to the United States and becomes a resident of the United States, and that individual receives, two years after giving up his Netherlands residence, a lump-sum pension in respect of his employment in the Netherlands, that lump-sum pension may be taxed by both the United States and the Netherlands. Pursuant to paragraph 7 of Article 25 (Methods of Elimination of Double Taxation), the source State generally will grant a credit against its tax on such payment in respect of taxes imposed on the payment in the State of residence of the recipient.

It is preferred, though not uniform, U.S. treaty policy not to distinguish in treatment between periodic and lump-sum pensions. It is the policy of the Netherlands, however, to preserve by treaty the right of the Netherlands to tax any lump-sum pension payment made in consideration of employment in the Netherlands. The

concern of the Netherlands is that the lump-sum payment might avoid tax altogether, or be subject to only a low rate of tax, even though the contributions on which the payment is based had been deductible for Netherlands tax purposes. Under the prior Convention, the Netherlands does preserve this taxing right. The rule in paragraph 2, therefore, represents a compromise between the United States and Netherlands positions.

Paragraph 3 modifies the rule in paragraph 2 with respect to certain lump-sum payments otherwise dealt with in paragraph 2. The portion of any such lump-sum payment that is contributed by the recipient to a pension plan or retirement account will not be taxable in the source State if certain conditions are met. Paragraph 2 will not to apply if the lump-sum payment that is rolled over into a pension plan or retirement account would not have been subject to current taxation in the State of the recipient's residence, had the payor been resident in the recipient's State of residence, and instead, would have been deferred until the amount of the payment is withdrawn from the pension plan or retirement account into which it was placed. Thus, if a lump-sum payment from a Netherlands pension plan is invested in a U.S. Individual Retirement Account ("IRA") and not taxed until the funds are withdrawn from the IRA, the payment will be free of Netherlands tax. Under these circumstances, the tax avoidance concerns of the Netherlands would not be present.

Paragraph 4 provides that pensions and other payments made by one of the States under the provisions of its social security system and other public pensions paid to a resident of the other State or to a citizen of the United States will be taxable only in the paying State. Pensions in respect of government service are not covered by this rule but by the rule of paragraph 2 of Article 20 (Government Service). The term "other public pensions" is defined in paragraph IX. of the Memorandum of Understanding to refer to United States tier 1 Railroad Retirement benefits. The reference to U.S. citizens is necessary to ensure that a social security payment by the Netherlands to a U.S. citizen not resident in the United States will not be taxable by the United States. This paragraph is one of the exceptions listed in paragraph 2(a) of Article 24 (Basis of Taxation) to the saving clause of paragraph 1 of that Article. Thus, the United States will not tax social security benefits paid by the Netherlands to a U.S. citizen who is a resident of the Netherlands.

Paragraph 6 deals with alimony payments. It provides that alimony payments to a resident of one of the States are taxable only by that State. The term "alimony" is defined for purposes of this paragraph as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, and lump-sum payments in lieu of such periodic payments. In addition, for a payment to be treated as "alimony" for purposes of this Article, it must be taxable to the

recipient under the laws of his State of residence.

It is standard U.S. treaty policy to provide a rule for child support payments that is the opposite of that provided for alimony. Under that rule child support payments by a resident of one State to a resident of the other are taxable only in the State of residence of the payor. The Convention contains no such rule. Child support payments, therefore, fall under the rule for "other income" in paragraph 1 of Article 23 (Other Income) that provides for exclusive taxation by the State of residence of the recipient. Such payments, however, are not currently taxable to the recipient under either Dutch or U.S. law (IRC section 71).

The provisions of this Article (except those of paragraph 4 dealing with social security benefits) are subject to the saving clause of paragraph 1 of Article 24 (Basis of Taxation). Thus, for example, a periodic pension, annuity, or an alimony payment received by a resident of the Netherlands who is a U.S. citizen may be taxed by the United States, regardless of the provision for exclusive residence taxation for those classes of income.

Article 20 - GOVERNMENT SERVICE

Subparagraphs (a) and (b) of paragraph 1 deal with the taxation of government compensation (other than a pension). Subparagraph (a) provides that wages, salaries, and similar compensation paid by one of the States or by its political subdivisions or local authorities to any individual are generally exempt from tax by the other State. Under subparagraph (b), such payments are, however, taxable in the other State and only in that State, if the services are rendered in that other State and the individual is a resident of that State who is either a national of that State or a person who did not become resident of that State solely for purposes of rendering the services.

Paragraph 2 deals with the taxation of a pension paid by, or out of funds created by, one of the States or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority. Subparagraph (a) provides that such a pension is taxable only in that State. Subparagraph (b) provides an exception under which such a pension is taxable only in the other State if the individual is a resident of, and a national of, that other State. Pensions paid to retired civilian and military employees of a Government of either State are intended to be covered under paragraph 2. Social security and similar benefits paid by a State in respect of services rendered to that State or a subdivision or authority are also intended to be covered.

Paragraphs 1 and 2 are similar to paragraphs 1 and 2 of Article 19 (Government Service) of the OECD Model Treaty. These

paragraphs differ from Article 19 of the U.S. Model under which such remuneration, including a pension, is taxable only in the Contracting State that pays it.

Paragraph 3 provides that the provisions of Articles 16 (Dependent Personal Services), 17 (Directors' Fees), and 19 (Pensions, Annuities, Alimony) shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by one of the States or a political subdivision or a local authority thereof. This treatment is consistent with the U.S. and OECD and Models, both of which exclude payments in respect of services rendered in connection with a business carried on by the governmental entity paying the compensation or pension.

Under paragraph 2(b) of Article 24 (Basis of Taxation), the saving clause (paragraph 1 of Article 24) does not apply to the benefits conferred by one of the States under Article 20 if the recipient of the benefits is neither a citizen of that State, nor, in the case of the United States, is a lawful permanent resident (i.e., a "green card" holder). Thus, for example, a Netherlands resident who receives a pension paid by the Netherlands in respect of services rendered to the Government of the Netherlands shall be taxable on this pension only in the Netherlands unless the individual is a U.S. citizen or acquires a U.S. green card.

Article 21 - PROFESSORS AND TEACHERS

Paragraph 1 provides an exemption from tax in one State for an individual who visits that State for a period not exceeding two years for the purpose of teaching or engaging in research at a university, college or other recognized educational institution in that State if the individual is a resident of the other Contracting State immediately before his visit begins. The exemption applies to any remuneration for such teaching or research. The exemption from tax applies for a period not exceeding two years from the date he first visits the Contracting State (the "host State") for the purpose of teaching or engaging in research at a university, college or other recognized educational institution there. If a professor or teacher remains in the host State for more than the specified two-year period, he may be subject to tax in that State, under its law, for the entire period of his presence. However, if the competent authorities so agree in a particular case, the exemption may apply for two years even if the individual's stay exceeds two years. It is anticipated that the competent authorities would agree to such an extension only in cases where the departure of the individual is delayed beyond the end of the two-year period because of unforeseen circumstances.

The host State exemption will apply if the teaching or research is carried on at an accredited university, college, school

or other recognized educational institution.

Paragraph 2 provides that Article 21 shall apply to income from research only if such research is undertaken by the individual in the public interest and not primarily for the benefit of some other private person or persons.

As stated in paragraph 3 of Article 22 ((Students and Trainees), an individual may not claim the benefits of this Article if, during the immediately preceding period, he has claimed the benefits of Article 22.

There is no provision in the U.S. or OECD Models dealing with professors and teachers. It is not standard U.S. treaty policy to provide benefits to visiting teachers by treaty. It is included in the Convention because a similar provision is found in the prior Convention. Under the prior Convention, however, the exemption applied for two years even if the individual's stay exceeded a two year duration.

Under paragraph 2(b) of Article 24 (Basis of Taxation), the saving clause (paragraph 1 of Article 24) does not apply to the benefits conferred by one of the States under Article 21 if the recipient of the benefits is neither a citizen of that State, nor, in the case of the United States, is a lawful permanent resident (i.e., a "green card" holder). Thus, a Netherlands resident who visits the United States for two academic years as a professor and becomes a U.S. resident according to the Code, other than by virtue of acquiring a green card, would continue to be exempt from U.S. tax in accordance with this article so long as he is not a U.S. citizen and does not acquire immigrant status in the United States. The saving clause does apply to U.S. citizens and immigrants.

Article 22 - STUDENTS AND TRAINEES

Article 22 deals with the taxation of visiting students and business apprentices, and certain other researchers and trainees. Paragraph 1 deals with individuals who are residents of one of the States (or who were residents of that State immediately before visiting the other State) and who are temporarily present in the other State (the "host State") in one of two capacities: (1) as a full-time student at a recognized educational institution in the host State, or (2) as a business apprentice. Such an individual will be exempt under paragraph 1 from tax in the host State on two types of receipts: (1) on payments remitted from outside the host State, which are for the purpose of the student's or trainee's maintenance, education or training, and (2) on remuneration for personal services performed in the host State on any amount that does not exceed $2,000 (or its equivalent in Netherlands guilders) for any taxable year. If the amount earned exceeds the $2,000 threshold, the exemption continues to apply to the first $2,000.

The excess is taxable according to the internal law of the host State. The $2,000 exemption does not reduce any personal exemptions and deductions otherwise allowable under internal law.

Paragraph 2 deals with an individual who is temporarily present in the host State for the purpose of study and who, immediately before his visit, is a resident of the other State. The individual dealt with in paragraph 2 is temporarily present in the host State for a period not exceeding three years for the purpose of study, research or training, and is the recipient of a grant, allowance or award either from a scientific, educational, religious or charitable organization, including host-State organizations, or under a technical assistance program entered into by one of the States or by a political subdivision or local authority thereof. Such an individual is exempt in the host State on the amount of the grant, allowance or award. He is also exempt on remuneration for personal services performed in the host State on any amount that does not exceed $2,000 (or its equivalent in Netherlands guilders) for any taxable year. Unlike the personal services exemption in paragraph 1, however, the services must be performed in connection with, or be incidental to, the individual's study, research or training. Thus, for example, up to $2,000 earned by a graduate student as a research assistant in his academic field would be exempt under paragraph 2. A similar amount earned, say, as a dishwasher in a campus restaurant would not be exempt under paragraph 2, though it may be exempt under paragraph 1. As with the exempt earned income provision in paragraph 1, if the amount earned exceeds the $2,000 threshold, the exemption still applies to the first $2,000. The excess is taxable according to the internal law of the host State. The $2,000 exemption does not reduce any personal exemptions and deductions otherwise allowable under internal law.

It is not standard U.S. treaty policy, particularly in treaties with developed countries, to include an earned income exemption for visiting students. This provision was agreed to in this treaty because it was important to the Netherlands Government, and essentially does no more than retain a provision from the prior Convention.

Paragraph 3 provides that an individual may not claim the benefits of this Article if, during the immediately preceding period, he has claimed the benefits of Article 21 (Professors and Teachers). As noted in connection with Article 21, the benefits of that Article may not be claimed immediately after claiming the benefits of this Article.

By virtue of paragraph 2(b) of Article 24 (Basis of Taxation), the saving clause (paragraph 1 of Article 24) does not apply to the benefits conferred by one of the States under Article 22 if the recipient of the benefits is neither a citizen of that State, nor, in the case of the United States, is a lawful permanent resident

(*i.e.*, a "green card" holder). Thus, a Netherlands resident who visits the United States under a U.S. Government grant to do research for two years at the National Institutes of Health, and becomes a U.S. resident during that period according to the Code, but other than by virtue of acquiring a green card, would continue to be exempt from U.S. tax in accordance with this article so long as he is not a U.S. citizen and does not acquire immigrant status in the United States. The saving clause does apply to U.S. citizens and immigrants.

Article 23 - OTHER INCOME

This Article provides the rules for the taxation of items of income not dealt with in the other articles of the Convention. An item of income is "dealt with" in an article when an item in the same category is a subject of the article, whether or not any treaty benefit is granted to that item of income. This Article deals both with classes of income that are not dealt with elsewhere, such as, for example, lottery winnings, and with income of the same class as income dealt with in another article of the Convention, but from sources in third States, and, therefore, not a subject of the other Article, if that article deals only with items of that class of income from sources within one of the States.

Paragraph 1 contains the general rule that such items of income derived by a resident of one of the States will be taxable only in the State of residence. This exclusive right of taxation applies irrespective of whether the residence State exercises its right to tax the income covered by the Article.

Paragraph 2 contains an exception to the general rule of paragraph 1 for income, other than income from real property, that is attributable to a permanent establishment or fixed base maintained in a Contracting State by a resident of the other Contracting State. The taxation of such income is governed by the provisions of Articles 7 (Business Profits) and 15 (Independent Personal Services). Thus, in general, third-country income which is attributable to a permanent establishment maintained in the United States by a resident of the Netherlands would be taxable by the United States. There is an exception to this rule for income from real property, as defined in paragraph 2 of Article 6 (Income from Real Property). If, for example, a Netherlands resident derives income from real property located outside the United States which is attributable to the resident's permanent establishment or fixed base in the United States, only the Netherlands and not the United States may tax that income. This special rule for foreign-situs real property is consistent with the general rule, also reflected in Article 6 (Income from Real Property), that only the situs and residence States may tax real property income. Even if such property is part of the property of a permanent

establishment or fixed base in a Contracting State, that State may not impose tax if neither the situs of the property nor the residence of the owner is in that State.

The rule in paragraph 3 of Article 24 (Basis of Taxation) dealing with deferred income and expenses of a permanent establishment or fixed base applies to paragraph 2 of this Article. Thus, income, gain or expense that is from third-country sources and that is attributable to a permanent establishment or fixed base, but is deferred until after the permanent establishment or fixed base no longer exists, may nevertheless be taxed or deducted, as the case may be, in the State in which the permanent establishment or fixed base was located. The rule in paragraph 3 of Article 24 dealing with gain from the alienation of property that had formed part of the business property of a permanent establishment or a fixed base also applies to paragraph 2 of Article 23. Thus, if an item of tangible personal property is used in connection with the derivation by a resident of one State of income attributable to a permanent establishment or fixed base in the other, but derived from sources outside either State, and that property is alienated after the property no longer forms part of the business property of the permanent establishment or fixed base, but within three years of that time, the State in which the permanent establishment or fixed base was located may tax the gain.

This Article is subject to the saving clause of paragraph 1 of Article 24 (Basis of Taxation). Thus, the United States may tax the income of a Netherlands resident not dealt with elsewhere in the Convention, if that Netherlands resident is a citizen of the United States, subject, however, to the special foreign tax credit provisions of paragraph 6 of Article 25 (Methods for the Elimination of Double Taxation).

Article 24 - BASIS OF TAXATION

There is no precise counterpart to Article 24 in other U.S. treaties. Provisions similar to paragraphs 1 and 2 of the Article, however, do appear in Article 1 of the U.S. Model, and the provisions of paragraph 3 appear in one of several forms in all recent U.S. treaties.

Paragraph 1 contains the traditional saving clause, and paragraphs 2 (a) and (b) contains the exceptions. These are found in paragraphs 3 and 4 of Article 1 (General Scope) of the U.S. Model.

Under paragraph 1 both States reserve their right, except as provided in paragraph 2, to tax their residents and nationals notwithstanding any Convention provisions to the contrary. The concept of "residence" for purposes of the Convention is defined in Article 4 (Resident). The term "national" is defined in Article 3

(General Definitions) to include individuals possessing the nationality or citizenship of one of the States as well as legal persons, partnerships and associations deriving their status as such from the laws in force in one of the States. In the U.S. Model the term "citizen" is used in the saving clause in place of the term "national." In general, the effect of this somewhat broader language in the Convention as compared with that in the U.S. Model will be minimal. A corporation that derives its status as a U.S. national from the laws in force in the United States is also a U.S. resident, and is, therefore, covered in the same way in the U.S. Model as in the Convention. A U.S. partnership that derives its status as such from the laws in force in the United States will not be a U.S. resident under the Convention because it will not be subject to U.S. tax. It will not, therefore, be affected by the saving clause.

The saving clause operates as follows: If, for example, a Netherlands resident performs independent personal services in the United States and the income from the services is not attributable to a fixed base in the United States, Article 15 (Independent Personal Services) would normally prevent the United States from taxing the income. If, however, the Netherlands resident is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules. (For special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in the Netherlands see paragraph 6 of Article 25 (Methods of Elimination of Double Taxation)). Residence, for the purpose of the saving clause, is determined under Article 4 (Resident). If, therefore, an individual who is not a U.S. citizen is a resident of the United States under the Code, and is also a resident of the Netherlands under Dutch law, and that individual has a permanent home available to him in the Netherlands and not in the United States, he would be treated as a resident of the Netherlands under Article 4 and for purposes of the saving clause. The United States would not be permitted to apply its statutory rules to that person if they are inconsistent with the Convention.

Also under paragraph 1, the United States reserves its right to tax former U.S. citizens, who are not nationals of the Netherlands, whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income tax. Such a former citizen is taxable in accordance with the provisions of section 877 of the Code for 10 years following the loss of citizenship. This provision is somewhat narrower than the "former citizen" rules in most recent U.S. treaties in two respects. First, it applies only to former citizens who are not citizens of the Netherlands. Second, it applies only in cases where the principal purpose of expatriation has been the avoidance of income tax, not all taxes, as in most U.S. treaties.

Paragraph 2 sets forth certain exceptions to the saving clause in cases where its application would contravene policies underlying provisions of the Convention that are intended to extend benefits of one of the States to its citizens and residents. Subparagraph 2(a) lists certain provisions of the Convention that will be applicable to all the citizens and residents of a State, despite the general saving clause rule of paragraph 1: (1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment, and, particularly, permits the override of the statute of limitations for the purpose of refunding tax under such a correlative adjustment. (2) Paragraph 4 of Article 19 (Pensions, Annuities, Alimony) deals with social security benefits. Its inclusion in the exceptions to the saving clause means that social security benefits paid by the Netherlands to a U.S. resident will, as intended, be taxed only by the Netherlands. (3) Article 25 (Methods of Elimination of Double Taxation) confers the benefit of double taxation relief by a State on its citizens and residents. To apply the saving clause to this Article would render the Article meaningless. (4) Article 28 (Non-Discrimination) prohibits discriminatory taxation by one State on the citizens and residents of the other. These prohibitions are intended to apply even if the citizen or resident is also a citizen or resident of the taxing State. (5) Article 29 (Mutual Agreement Procedure) may confer benefits by a State on its citizens and residents. For example, the statute of limitations may be waived for refunds, the competent authorities are permitted to use a definition of a term which differs from the internal law definition, or they may refer an issue to an arbitration panel. As with the foreign tax credit, these benefits are intended to be granted by a State to its citizens and residents.

Subparagraph 2(b) provides a different set of exceptions to the saving clause. The effect of this provision is to extend certain benefits to are persons who are not citizens of one of the States, and, in the case of the United States, to persons who are not lawful permanent residents (i.e., "green card" holders). If, for example, beneficiaries of these provisions come to the United States from the Netherlands and remain in the United States long enough to become residents under the Code, but do not acquire immigrant status (i.e., they do not become "green card" holders) and are not citizens of the United States, the United States will continue to grant these benefits even if they conflict with the Code rules. The benefits preserved by this paragraph are the host country exemptions for the following items of income: Government service salaries and pensions under Article 20 (Government Service); certain income of visiting teachers under Article 21 (Professors and Teachers); certain income of students and trainees under Article 22 (Students and Trainees); and the income of diplomatic and consular officers under Article 33 (Diplomatic Agents and Consular Officers).

Paragraph 3 of the Article elaborates on the following

provisions: paragraphs 1 and 2 of Article 7 (Business Profits), paragraph 5 of Article 10 (Dividends), paragraph 3 of Article 12 (Interest), paragraph 3 of Article 13 (Royalties), paragraph 3 of Article 14 (Capital Gains), paragraph 1 of Article 15 (Independent Personal Services) and paragraph 2 of Article 23 (Other Income). This paragraph incorporates the rule of Code section 864(c)(6) into the Convention. Like the Code section on which it is based, Paragraph 4 of the Protocol provides that any income or gain attributable to a permanent establishment or a fixed base, depending on the context, during its existence is taxable in the Contracting State where the permanent establishment or fixed base is situated even if the payments are deferred until after the permanent establishment or fixed base no longer exists. The provision in paragraph 3 clarifies that expenses attributable to the permanent establishment or fixed base during its existence may be deducted from the deferred income at such time as that income is subject to tax. The preceding rule regarding the taxation of deferred income and the allowance of appropriate expenses against such income will not affect any rules in the internal laws of the States relating to the accrual of income and expenses. For example, income arising from an installment sale that is recognized for U.S. tax purposes in years subsequent to the year of the sale will be recognized in accordance with section 453 of the Code.

Paragraph 3 also contains a rule dealing with the taxation of gain from the alienation of personal property which, at any time, had formed part of the business property of a permanent establishment or a fixed base that a resident of one of the States had in the other. That other State may tax that part of the gain that is attributable to the period during which the property formed part of the business property of the permanent establishment or fixed base. The tax may be imposed at the time that the gain is realized and recognized under the laws of the taxing State, but only if that date is within three years of the time that the property ceased to be part of the business property of the permanent establishment or fixed base. This incorporates into the Convention a rule similar to that of Code section 864(c)(7). Under the Code rule, if an asset which had been part of the business property of a U.S. trade or business (or, in a treaty context, of a permanent establishment or fixed base in the United States) is alienated within ten years of its removal from the U.S. trade or business (or permanent establishment/fixed base), the gain realized on such alienation is subject to U.S. tax. Under the rule in paragraph 3, a right of the State in which the permanent establishment or fixed base exists or existed to tax such gains is confirmed, but the taxable gain is limited to that portion which accrued during the time that the asset formed part of the business property of the permanent establishment or fixed base, and the look-back period is limited to three years.

Article 24 of the Convention prior to the Protocol contained a paragraph 4 that was deleted by the Protocol. That paragraph

identified the issue of the so-called "triangular case" and called for negotiation of a Protocol to deal with it if the problem had not been resolved by Dutch legislative action prior to the Senate Foreign Relations Committee hearings on the Convention. Articles 1 and 2 of the Protocol amend Articles 12 (Interest) and 13 (Royalties) to deal with this issue.

Article 25 - METHODS OF ELIMINATION OF DOUBLE TAXATION

This Article describes the manner in which each State undertakes to relieve double taxation. The United States uses the foreign tax credit method exclusively. The Netherlands uses a combination of foreign tax credit and exemption methods, depending on the nature of the income involved.

Paragraphs 1, 2, 3 and 8 set forth rules for double taxation relief in the Netherlands, subject to certain special provisions in paragraphs 6 and 7. Paragraphs 1 and 2 deal with those items of income in respect of which double taxation is eliminated by the Netherlands by means of exemption; paragraphs 3 and 8 deal with those items of income for which the Netherlands will provide a foreign tax credit under the Convention.

Paragraph 1 clarifies that, notwithstanding the fact that under the exceptions to the saving clause (paragraphs 2(a) and (b) of Article 24 (Basis of Taxation) the Netherlands may not tax certain income of its citizens and residents from U.S. Government service or U.S. social security benefits, and despite the fact that these items of income are exempt from Netherlands tax under paragraph 2 of Article 25, the Netherlands may include these items of income for purposes of computing the exemption with progression under paragraph 2. Thus, such items are included in income solely for the purpose of determining the rate of tax on other items of income that are taxable in the Netherlands.

Paragraph 2 provides that the Netherlands will exempt, with progression, a number of items of income received by a resident or a national of the Netherlands that, under the Convention, may be taxed by the United States. The following items of income are specified: U.S. situs real property taxable by the United States under Article 6 (Income from Real Property); profits attributable to a U.S. permanent establishment and taxable by the United States, to the extent such income is subject to United States tax under Article 7 (Business Profits); dividends, interest, and royalties attributable to a U.S. permanent establishment or fixed base and, therefore, taxable on a net basis by the United States under paragraph 5 of Article 10 (Dividends), paragraph 3 of Article 12 (Interest) or paragraph 3 of Article 13 (Royalties), respectively; gains from the disposition of U.S. situs real property or a U.S. real property interest, or gain from the alienation of personal property forming part of the property of a U.S. permanent

establishment or fixed base, and taxable in the United States under paragraphs 1 and 3 of Article 14 (Capital Gains); income from the performance of independent personal services in the United States, to the extent such income is subject to U.S. tax under Article 15 (Independent Personal Services); income from the performance of dependent personal services in the United States which is taxable by the United States under paragraph 1 of Article 16 (Dependent Personal Services); social security benefits taxable by the United States under paragraph 4 of Article 19 (Pensions, Annuities, Alimony); remuneration and pensions for Government service taxable by the United States under Article 20 (Government Service); and income attributable to a permanent establishment or fixed base taxable by the United States under paragraph 2 of Article 23 (Other Income). Although no Netherlands tax is imposed in respect of these items of income, they are included in income for purposes of determining the appropriate rate of tax to be imposed on those items of income that remain taxable in the Netherlands (i.e., exemption with progression). The reduction in Netherlands tax is calculated in conformity with the law of the Netherlands for the avoidance of double taxation. The requirement that income described in Article 7 (Business Profits) be subject to United States tax in order to be exempt from Netherlands tax was added by Article 4 of the Protocol.

Under paragraph 3, United States tax on certain items of income is allowed as a credit against Netherlands tax. A credit is allowed for dividends subject to U.S. withholding tax under paragraph 2 of Article 10 (Dividends), and for directors' fees and remuneration of entertainers and athletes subject to U.S. tax under Articles 17 (Directors' Fees) and 18 (Artistes and Athletes), respectively. The credit for direct investment dividends is equal to the 5 percent U.S. tax imposed under subparagraph 2(a) of Article 10 (Dividends). The credit is 15 percent for portfolio dividends that are taxable under subparagraph 2(b) of Article 10. The Netherlands credit for REIT dividends is limited to 15 percent, notwithstanding the fact that REIT dividends, other than those beneficially owned by individuals holding less than a 25 percent interest in the REIT, are subject to the full U.S. statutory rate of withholding of 30 percent. The credit for the remuneration of directors, entertainers and athletes is to be the amount of the U.S. tax imposed on the income. A limitation on the foreign tax credit is provided, based on Netherlands law.

The basic provision for the United States foreign tax credit is found in paragraph 4, subject to certain special provisions in paragraphs 5, 6 and 7. Under paragraph 4, the United States agrees to allow to its nationals and residents a credit against U.S. tax for the appropriate amount of income taxes paid or accrued to the Netherlands. The credit under the Convention is allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of this Article (i.e., the allowance of a credit)

is retained. Thus, although the Convention provides for a foreign tax credit, the terms of the credit are determined by the provisions, at the time a credit is given, of the U.S. statutory credit.

Subparagraph 4(b) provides for a deemed-paid credit, consistent with section 902 of the Code, to a U.S. corporation in respect of dividends received from a Netherlands corporation in which the U.S. corporation owns at least 10 percent of the voting stock. This credit is for the tax paid by the Netherlands corporation on the earnings out of which the dividends are considered paid.

As indicated, the U.S. credit under the Convention is subject to the limitations of U.S. law, which generally limit the credit against U.S. tax to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code section 904(a)). Nothing in the Convention prevents the limitation of the U.S. credit from being applied on a per-country or overall basis or on some variation thereof. In general, where source rules are provided in the Convention for purposes of determining the taxing rights of the Contracting States, these are consistent with the Code source rules for foreign tax credit and other purposes. Where, however, there is an inconsistency between Convention and Code source rules, the Code source rules (e.g., Code section 904(g)) will be used to determine the limits for the allowance of a credit under the Convention. (Paragraph 6 of the Article provides an exception to this general rule with respect to certain U.S. source income of U.S. citizens resident in the Netherlands.)

Paragraph 4 also provides that the Netherlands income taxes specified in paragraphs 1(a) and 2 of Article 2 (Taxes Covered) are to be treated as income taxes for purposes of allowing a credit under the paragraph. It was the understanding of the negotiators that each of the Netherlands income taxes specified in Article 2 for which credit is allowed under paragraph 4 are creditable taxes under the Code.

Paragraph 5 provides special rules for the U.S. foreign tax credit for the Netherlands profit share imposed on oil-related income. Although the Convention explicitly includes the profit share as a covered tax under Article 2 (Taxes Covered), paragraph 5 of Article 25 limits the extent to which the profit share may be credited against U.S. tax liability when paid or accrued by U.S. residents. Unlike the other Dutch taxes described in Article 2 (Taxes Covered) it has not been determined whether the profit share paid or accrued by U.S. residents is creditable under U.S. Treasury Department regulations. While generally it is no longer U.S. policy to provide a treaty credit for foreign taxes on oil and gas extraction income like the Dutch profit share, the U.S. income tax treaties with the Netherlands' North Sea competitors, the United

Kingdom and Norway, do so. From a policy perspective, it is desirable to treat the North Sea oil-producing states similarly for this purpose. Moreover, as explained below, in many cases the limited creditability of the profit share in accordance with paragraph 5 will not result in any cost to the U.S. fisc. Given these considerations, the U.S. agreed in the negotiations to provide a limited credit for the profit share, in accordance with the rules set forth under paragraph 5.

The profit share is imposed on income from petroleum reconnaissance, exploration, and production activities in the Netherlands. For this purpose, the Netherlands includes its territorial sea and the Dutch part of the continental shelf. Under Dutch law, the profit share is levied to the extent that the calculated profit share exceeds the company tax. However, the profit share actually due is a deduction in computing the taxable base for purposes of imposing the company tax. The company tax is equal to 35 percent of the taxable income less the profit share paid. The profit share generally is equal to 50 percent of the taxable income, with a credit for the company tax. Determining each amount requires solution of simultaneous equations. The following example illustrates the interaction of the Dutch company tax and profit share.

Assume that a taxpayer recognizes $100 of income from Dutch sources that is subject to both the profit share and the company tax. The Dutch profit share and company tax with respect to this income are calculated as follows:

Profit	$100
Company Tax Rate	35%
Profit Share Tax Rate	50%

A = Company Tax
B = Profit Share
A = .35 (100-B)
B = (.5 X 100)-A
A = $26.92
B = $23.08

Thus, the total amount of taxes paid in the Netherlands (*i.e.*, profit share plus company tax) is $50.00. In many cases, the fact that a limited credit is allowed under paragraph 5 will result in no current reduction in the U.S. tax burden of the person claiming the credit. If the tax were not creditable, the profit share would be treated as a deductible expense for U.S. tax purposes, and would be deducted from the U.S. taxpayer's income for purposes of determining its U.S. foreign tax credit limitation. Thus, under the above example, the taxpayer's taxable income for U.S. tax purposes would be $76.92 (*i.e.*, $100 minus the $23.08 in profit share). The taxpayer's U.S. foreign tax credit limitation would be $26.92 (*i.e.*, 35% of $76.92). Since the taxpayer paid $26.92 in

company tax under the facts of the example, the taxpayer would have no U.S. income tax liability with respect to the income subject to the profit share even if the profit share were not creditable.

The amount of U.S. credit for the company tax is computed under the generally applicable rules of paragraph 4 of Article 25. It is intended that the taxpayer will be permitted to claim a total credit in respect of company tax and profit share in an amount up to the product of the current U.S. rate and the amount of income derived from Netherlands sources. The amount of U.S. credit for the profit share is limited by paragraph 5 to the "appropriate amount." The appropriate amount is defined as the product of the "creditable profit share income base" and the maximum U.S. statutory tax rate applicable to the taxpayer for the taxable year. The "creditable profit share income base" is defined in subparagraph 5(a) as the excess of "the income subject to the company tax (excluding income not subject to the profit share)" that is derived from sources within the Netherlands (before deduction of the profit share due) over the "creditable company income tax base." The "creditable company income tax base" is defined in subparagraph 5(b) as the "effective company income tax rate" divided by the maximum U.S. statutory tax rate applicable to the taxpayer for the taxable year, multiplied by the income subject to the company income tax (excluding the income not subject to the profit share) that is derived from sources within the Netherlands (before deduction of the profit share due). To clarify the intention of the negotiators, the delegations have exchanged letters expressing their agreement that for all U.S. tax purposes, including the U.S. limitation on the company tax, the term "creditable company income tax base" shall in no case exceed the income subject to the company income tax (excluding the income subject to the profit share), as determined under the principles of U.S. tax law. The "effective company income tax rate" is defined in subparagraph 5(c) as the company income tax paid on the income subject to the company tax (excluding the income not subject to the profit share) divided by the income subject to the company income tax, excluding the income not subject to the profit share and before deduction of the profit share.

Paragraph 5 provides that the appropriate amount is subject to any other limitations imposed by the law of the United States, as it may be amended from time to time, that apply to taxes creditable under sections 901 and 903 of the Code. Thus, the total amount of U.S. credit with respect to the profit share and company tax may not exceed an amount equal to the income base for company tax purposes, without deduction of the profit share (but reduced by the amount of any income not subject to the profit share), multiplied by the maximum U.S. corporate income tax rate for the year.

The term "the income subject to the company tax (excluding income not subject to the profit share)" in subparagraphs 5(a), (b) and (c) is not defined in the Convention. Accordingly, pursuant to

paragraph 2 of Article 3 (General Definitions), this term is to be defined in accordance with U.S. tax law principles. The application of this paragraph is illustrated by the following examples.

Example 1. A U.S. person with a permanent establishment in the Netherlands is subject to the company tax and the profit share. The amount of taxable income for that year determined under U.S. and Dutch principles is $100. The person paid company tax of $26.92 and profit share of $23.08 with respect to this income.

First, the "effective company tax rate" is determined in accordance with subparagraph 5(c) by dividing the company tax paid by the income subject to the company tax, without deduction of the profit share, or .2692 [i.e., $26.92/$100].

Second, the "creditable company income tax base" is determined in accordance with subparagraph 5(b) by dividing the effective company tax rate by an amount equal to the maximum U.S. rate, multiplied by the income subject to the company tax, without deduction of the profit share, or $76.91 [i.e., .2692/.3500 X $100]. The limitation on the credit for the company income tax paid is the product of the U.S. tax rate and the creditable company income tax base, or $26.92 [i.e., .35 X $76.91].

Third, in accordance with subparagraph 5(a), the "creditable profit share income base" is equal to the excess of the income subject to the company tax over the creditable company income tax base, or $23.09 [i.e., $100 - $76.91].

Finally, the "appropriate amount," i.e., the limitation on the credit for the profit share, is the product of the creditable profit share income base and the maximum U.S. rate, or $8.08 [i.e., $23.09 X .35].

The limitation on the company tax is the amount paid, $26.92. The total tax paid to the Netherlands that is eligible for the foreign tax credit is $26.92 plus $8.08, or $35.00. The U.S. taxpayer paid a total of $50.00 ($23.08 in profit share, plus $26.92 in company tax) to the Netherlands. Consequently, the U.S. taxpayer pays no U.S. income tax with respect to the $100 Netherlands source income and has $15 ($23.08 - $8.08) in excess profit share to utilize in a carryover or carryback year, subject to the restrictions of the Convention.

Example 2. The facts are the same as in Example 1, except that the amount of taxable income determined under U.S. principles is $90 rather than $100.

First, the "effective company tax rate" is determined in accordance with subparagraph 5(c) by dividing the company tax paid by the income subject to the company tax, without deduction of the

profit share, or .2991 [i.e., $26.92/$90].

Second, the "creditable company income tax base" is determined in accordance with subparagraph 5(b) by dividing the effective company tax rate by an amount equal to the maximum U.S. rate, multiplied by the income subject to the company tax, without deduction of the profit share, or $76.91 [i.e., .2991/.3500 X $90]. The limitation on the credit for the company income tax paid is the product of the U.S. tax rate and the creditable company income tax base, or $26.92.

Third, in accordance with subparagraph 5(a), the "creditable profit share income base" is equal to the excess of the income subject to the company tax over the creditable company income tax base, or $13.09 [i.e., $90 - $76.91].

Finally, the "appropriate amount" is equal to the product of the U.S. tax rate and the creditable profit share income base, or $4.58 [i.e., $13.09 X .35].

The credit for the company tax is the amount paid, $26.92. The total tax paid to the Netherlands that is eligible for the foreign tax credit is $26.29 plus $4.58, or $31.50. The U.S. taxpayer paid a total of $50.00 ($23.08 in profit share, plus $26.92 in company tax) to the Netherlands. Consequently, the U.S. taxpayer pays no U.S. income tax with respect to the $90 in Netherlands source income and has $18.50 ($23.08 - $4.58) in excess profit share to utilize in a carryover or carryback year, subject to the restrictions of the Convention.

The Convention permits a limited carryback and carryover of the profit share on oil and gas extraction income from oil and gas wells in the Netherlands that, under the special limitation provided by paragraph 5, cannot be credited in the year paid or accrued. The profit share may be carried to those years specified under U.S. law and credited in those years subject to the Convention's special limitation as applied in those years. Other limitations, such as those provided by Code section 907, also may apply.

The profit share is not eligible for a foreign tax credit under paragraph 4. If the provisions of the Convention are relied upon to claim a foreign tax credit for the profit share, the limitations of paragraph 5 apply, whether or not the profit share is paid in the taxable year, and all Dutch income taxes must be treated as provided in the Convention. Thus, with respect to income taxes paid or accrued to the Netherlands on income other than oil and gas income from reconnaissance, exploration, and production activities in the Netherlands, the credit allowed under paragraph 4 to such persons under the Convention is limited to the U.S. income tax attributable to such other income.

Paragraph 6 of Article 25 provides special rules for the tax treatment in both States of certain types of income derived from U.S. sources by U.S. citizens who are resident in the Netherlands. Since U.S. citizens are subject to United States tax at ordinary progressive rates on their worldwide income, the U.S. tax on the U.S. source income of a U.S. citizen resident in the Netherlands may exceed the U.S. tax that may be imposed under the Convention on an item of U.S. source income derived by a resident of the Netherlands who is not a U.S. citizen.

Subparagraph (a) of paragraph 6 provides special Netherlands credit rules with respect to items of income for which the Netherlands allows a foreign tax credit rather than an exemption under paragraph 2 (and which are not subject to the special credit rules of paragraph 7), and which are either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the Convention when received by Netherlands residents who are not U.S. citizens. The Netherlands foreign tax credit allowed by paragraph 6(a) under these circumstances, to the extent consistent with Netherlands law, need not exceed the U.S. tax which may be imposed under the provisions of the Convention, other than tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of paragraph 1 of Article 24 (Basis of Taxation). Thus, if a U.S. citizen resident in the Netherlands receives U.S. source portfolio dividends, the Netherlands foreign tax credit would be limited to 15 percent of the dividend -- the U.S. tax that may be imposed under subparagraph 2(b) of Article 10 (Dividends) -- even if the shareholder is subject (before the special U.S. foreign tax credit and source rules provided for in subparagraphs 3(b) and 3(c)) to a U.S. rate of tax of 36 percent because of his U.S. citizenship. With respect to royalty or interest income, the Netherlands would allow no foreign tax credit, because Netherlands residents are exempt from U.S. tax on these classes of income under the provisions of Articles 12 (Interest) and 13 (Royalties).

Subparagraph 6(b) eliminates the potential for double taxation that can arise as a result of the absence of a full Netherlands foreign tax credit, because of subparagraph 6(a), for the U.S. tax imposed on its citizens resident in the Netherlands. The subparagraph provides that the United States will credit the Netherlands income tax paid, after allowance of the credit provided for in subparagraph 6(a). It further provides that in allowing the credit, the United States will not reduce its tax below the amount that is allowed as a creditable tax in the Netherlands under subparagraph 6(a). Since the income described in this paragraph is U.S. source income, special rules are required to resource some of the income as Netherlands source in order for the United States to be able to credit the Netherlands tax. This resourcing is provided for in subparagraph 6(c), which deems the items of income referred to in subparagraph 6(a) to be from Netherlands sources to the extent necessary to avoid double taxation under subparagraph 6(b).

The following two examples illustrate the application of paragraph 6 in the case of a U.S. source portfolio dividend received by a U.S. citizen resident in the Netherlands. In both examples, the U.S. rate of tax on the Netherlands resident under paragraph 2(b) of Article 10 (Dividends) of the Convention is 15 percent. In both examples the U.S. income tax rate on the U.S. citizen is 36 percent. In example I the Netherlands income tax rate on its resident (the U.S. citizen) is 25 percent (below the U.S. rate), and in example II the Netherlands rate on its resident is 40 percent (above the U.S. rate).

	Example I	Example II
Subparagraph 6(a)		
U.S. dividend declared	$100.00	$100.00
Notional U.S. withholding tax per Article 10(2)(b)	15.00	15.00
Netherlands taxable income	100.00	100.00
Netherlands tax before credit	25.00	40.00
Netherlands foreign tax credit	15.00	15.00
Net post-credit Netherlands tax	10.00	25.00
Subparagraphs 6(b) and (c)		
U.S. pre-tax income	$100.00	$100.00
U.S. pre-credit citizenship tax	36.00	36.00
Notional U.S. withholding tax	15.00	15.00
U.S. tax available for credit	21.00	21.00
Income resourced from U.S. to Netherlands	58.33	58.33
U.S. tax on resourced income	21.00	21.00
U.S. credit for Netherlands tax	10.00	21.00
Net post-credit U.S. tax	11.00	0.00
Total U.S. tax	26.00	15.00

In both examples, in the application of subparagraph 6(a), the Netherlands credits a 15 percent U.S. tax against its residence tax on the U.S. citizen. In example I the net Netherlands tax after foreign tax credit is 10.00; in the second example it is 20.00. In the application of subparagraphs 6(b) and (c), from the U.S. tax due before credit of 36.00, the United States subtracts the amount of the U.S. source tax of 15.00, against which no U.S. foreign tax credit is be allowed. This provision assures that, at a minimum, the United States will collect the tax that it is due under the Convention as the source country. In both examples, the maximum amount of U.S. tax against which credit for Netherlands tax may be claimed is 21.00. Initially, all of the income in these examples was U.S. source. In order for a U.S. credit to be allowed against 21.00 of U.S. tax, the amount of income that, given a tax rate of 36 percent, generates a tax of 21.00 must be resourced as Netherlands source. Thus, 58.33 of income (21.00 divided by .36)

is resourced. In example I, the Netherlands tax was 10.00. When this amount is credited against the U.S. tax on the resourced Netherlands income, there is a net U.S. tax of 11.00 due after credit. In example II, the Netherlands tax was 25, but, because of the resourcing, only 21.00 is eligible for credit, since, under subparagraph 6(c), the amount of resourcing is limited to that necessary to avoid double taxation. Thus, even though the Netherlands tax was 25.00 and the U.S. tax available for credit was 21.00, there is no excess credit available for carryover.

Paragraph 7 provides special credit rules for three items of income in respect of which the former State of residence of the income recipient is given a taxing right under the Convention. These are lump-sum pensions derived by a resident of one of the States in respect of an employment exercised in the other State and lump sums derived by a resident of that State, paid in lieu of the right to receive annuities, if the recipient had been a resident of the other State at any time during the preceding five year period (paragraph 2 of Article 19 (Pensions, Annuities, alimony), and gain realized by a resident of one State on the sale of shares of a corporation resident in the other State where the alienator (alone or together with related individuals) owns at least 25 percent of any class of shares of the corporation (paragraph 9 of Article 14 (Gains)). These are not exclusive taxing rights. Both States have the right to tax. Paragraph 7 of Article 25 provides, with respect to these items of income, that the State of former residence, rather than the present State of residence of the recipient of the income is required to give the credit. The paragraph provides a limit equal to that part of the income tax, before the paragraph 7 credit is taken, attributable to that income. The paragraph also provides that, where the United States is required to give a credit under this paragraph, the source of the items of income in respect of which credit is allowed shall be deemed to be the Netherlands to the extent necessary to allow the granting of the credit under this paragraph, even if the income is from U.S. sources under the Internal Revenue Code.

Paragraph 8 was added by Article 4(2) of the Protocol. It provides that in cases in which the United States imposes a withholding tax of 15 percent on interest (in accordance with paragraph 8 of Article 12 (Interest)) or royalties (in accordance with paragraph 6 of Article 13 (Royalties)), and the income subject to the withholding tax is included in the basis of taxation by the Netherlands and is not exempt from tax in the Netherlands, the Netherlands generally will extend a credit equal to 15 percent of the interest or royalties paid.

This Article is not subject to the saving clause of paragraph 1 of Article 24 (Basis of taxation), by virtue of the exception in paragraph 2(a). Thus, the United States will allow a credit to its citizens and residents in accordance with the Article, even if such credit were to provide a benefit not available under the Code.

Article 26 - LIMITATION ON BENEFITS

Article 26 assures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State -- and are not extended to residents of third States that do not have a substantial business in, or business nexus with, the other Contracting State. For example, a resident of a third State might establish an entity resident in a Contracting State for the purpose of deriving income from the other Contracting State and claiming source State benefits with respect to that income. Absent Article 26, the entity generally would be entitled to benefits as a resident of a Contracting State, as long as it qualified as a resident of a Contracting State under Article 4 (Resident) and the form of the transaction was respected by the competent authorities of the Contracting States.

Article 26 is unprecedented in its complexity and level of detail. Such detail is normally not desirable from the standpoint of simplicity and because it increases the chance of inadvertent error. In this case, however, the two delegations each had a significant concern that only could be addressed by additional complexity. The Netherlands delegation was concerned that a provision modelled after the provisions in such recent agreements as the U.S.-Germany convention would be too general to provide sufficient certainty to legitimate Dutch investors in the United States. The Netherlands therefore asked that more precise guidance be provided under the provision.

In addition, the United States was willing to agree to somewhat looser standards for entitlement to benefits than the analogous provisions of other recent conventions only if there were adequate safeguards that the beneficiaries of these provisions had a sufficient nexus to the Netherlands to be entitled to treaty benefits from a policy perspective. As with the Dutch desire for certainty, these safeguards often manifested themselves in increased complexity. In the end, therefore, the delegations were driven by two concerns, each of which resulted in increased complexity.

The structure of Article 26 is as follows: Paragraphs 1 through 4 set forth a series of tests under which a resident of a Contracting State may be entitled to treaty benefits. Satisfaction of any of these tests will entitle that person to some or all of the benefits of the Convention in the other Contracting State. Paragraph 5 sets forth a base erosion test that is employed under certain provisions of other paragraphs of the Article. Paragraph 6 sets forth a special test for shipping and air transport. Paragraph 7 provides that the competent authority of the source State may grant treaty benefits to a person not otherwise entitled to benefits under the other paragraphs of the Article. Finally, Paragraph 8 defines several terms that are employed in Article 26.

It is anticipated that as the competent authorities and taxpayers gain more experience with the concepts in this Article, some of which are relatively new, further guidance will be developed and made public with the objective of alleviating the compliance burden for taxpayers attempting to establish their entitlement to benefits under Article 26. Paragraph X. of the Memorandum of Understanding reflects this view, providing that while a taxpayer must be able to provide upon request sufficient evidence to establish the taxpayer's entitlement to benefits, the competent authorities will attempt to develop reasonable procedures for periodic reporting of the facts necessary to support a claim to benefits. It is anticipated that these procedures will permit a taxpayer to enjoy the benefits of the Convention without providing annual evidence of such entitlement, as long as the taxpayer has adequately documented its entitlement to benefits for a particular year and there has been no relevant change in the facts and circumstances.

The operative rules of paragraphs 1 through 7 apply numerous terms that are defined in paragraph 8. These definitions are described first, followed by a description of the rules of paragraphs 1 through 7 that apply these definitions.

Defined Terms - Paragraph 8

Subparagraphs (a) through (m) of paragraph 8 set forth thirteen defined terms that are used in Article 26. These definitions are discussed below.

Principal Class of Shares - Subparagraph 8(a)

The term "principal class of shares" is defined in subparagraph 8(a). It is relevant for the publicly-traded tests under subparagraph 1(c). The principal class of shares is the class of shares that represents the majority of the voting power and value of the company. In most cases this class will be the ordinary or common shares of the company. If no single class of shares represents the majority of the voting power and value of the company, the principal class of shares will be the classes of shares that in the aggregate possess more than 50 percent of the voting power and value of the company. Authorized but unissued shares are not considered for purposes of determining voting power. In addition, the principal class of shares must include any "disproportionate class of shares," which is defined in subparagraph 8(c) (discussed below). Further, the competent authorities may agree to consider any restrictions or limitations on voting rights of issued shares in determining voting power. For instance, the voting power of stock with restricted voting rights could be discounted or disregarded by the competent authorities. They also may identify, by mutual agreement procedure, a principal class of shares that differs from that identified in accordance with the rules set forth in paragraph 8.

Shares - Subparagraph 8(b)

The term shares itself is not defined. In accordance with paragraph 2 of Article 3 (General Definitions), the term shall have the meaning that it has under the tax law of the State concerning the taxes to which the Convention applies. Therefore, in determining whether a Netherlands company qualifies for treaty benefits with respect to income derived from the United States, the term "shares" will have the meaning associated with that term in the United States for purposes of United States domestic tax law.

Subparagraph 8(b) provides that in addition to the commonly understood meaning attached to the term, "shares" also shall include depository receipts and trust certificates thereof. This provision reflects the practice in the Netherlands for shareholders of some publicly-traded companies to place their shares in a trust company, or "administratiekantoor." The trust then issues trust certificates, or "certificaten van aandelen," to the shareholders. The trust certificates are then listed and traded on a stock exchange in lieu of the share certificates. Paragraph I. of the Agreed Minutes to the Protocol clarifies that it is understood that such instruments will be considered to possess the rights (including voting rights) attached to the shares that they replace. Therefore, the shares of a company will include the trust certificates that replace the principal class of shares of a publicly-traded company, and the actual share certificates that the trust certificates replace will be disregarded. Similarly, American Depository Receipts ("ADRs"), which are frequently issued to United States investors in foreign corporations in order to evidence their ownership of the underlying foreign shares and to facilitate their holding and trading of such interests, will be treated as the equivalent of the underlying shares.

Disproportionate Class of Shares - Subparagraph 8(c)

Subparagraph 8(c) sets forth the definition of a disproportionate class of shares. Subparagraph 8(a) provides that such a class of shares must be included within the principal class of shares. A disproportionate class of shares of a company resident in a State is any class of shares that entitles the shareholder to a disproportionately higher participation in the earnings that the company generates in the other State through particular assets or activities of the company. Such participation may take any form, including (but not limited to) dividends and redemption payments. A disproportionate class of shares would include so-called alphabet stock that entitles the holder to earnings in the source State produced by a particular division of the company. The following examples illustrate the application of this subparagraph.

<u>Example 1</u>. NLCo is a corporation resident in the Netherlands. NLCo has two classes of shares: Common and

Preferred. The Common shares are listed on the Amsterdam Stock Exchange and are substantially and regularly traded. The Preferred shares have no voting rights and are entitled to receive dividends equal in amount to interest payments that NLCo receives from unrelated borrowers in the United States. The Common shares account for more than 50 percent of the value of NLCo and for 100 percent of the voting power. Because the owner of the Preferred shares is entitled to receive payments corresponding to the U.S. source interest income earned by NLCo, the Preferred shares are considered to be a disproportionate class of shares. Pursuant to subparagraph 8(a), the principal class of shares of NLCo includes the Common and Preferred shares.

Example 2. USCo is a corporation resident in the United States. USCo has two classes of shares: Common and Preferred. The Common shares are listed on the New York Stock Exchange and are substantially and regularly traded. The Preferred shares have no voting rights and are entitled to receive dividends equal in amount to the income earned by a division of USCo that sells widgets in the United States. Because the Preferred shares do not entitle the owner to receive dividends or other payments corresponding to Netherlands-source income received by USCo, the Preferred shares are not considered a disproportionate class of shares for purposes of subparagraph 8(c).

Recognized Stock Exchange - Subparagraph 8(d)

Subparagraph 8(d) provides that the term "recognized stock exchange" generally means (i) any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934; (ii) the Amsterdam Stock Exchange; (iii) the NASDAQ System or the parallel market of the Amsterdam Stock Exchange; and (iv) any other stock exchange agreed upon by the competent authorities of the States. Paragraph VI. of the Agreed Minutes to the Protocol sets forth the agreement of the competent authorities that the principal stock exchanges of Frankfurt, London, Paris, Brussels, Hamburg, Madrid, Milan, Sydney, Tokyo and Toronto will be considered to be recognized stock exchanges. Other exchanges may be added by agreement of the competent authorities. With respect to "closely held companies" (discussed below), stock exchanges listed under (iii), above, will not be considered to be recognized stock exchanges. In addition, the stock exchanges described in (iv), above, also will not be considered to be recognized stock exchanges with respect to closely held companies if the competent authorities agree to exclude them.

Closely Held Company - Subparagraph 8(e)

Subparagraph 8(e) defines the term "closely held company." A company will be considered to be a closely held company if 50 percent or more of the principal class of shares (as defined under

subparagraph 8(a)) is owned by persons who are not "qualified persons" (as defined in subparagraph 8(g) or "residents of a member state of the European Communities" (as defined in subparagraph 8(i)), each of whom owns, directly or indirectly, alone or together with related persons more than 5 percent of such shares for more than 30 days during a taxable year. For this purpose, paragraph XXIII. of the Memorandum of Understanding clarifies that it is understood that "related persons" means associated enterprises (as meant in Article 9 (Associated Enterprises) and their owners. Since Article 9 is understood to incorporate into the Convention the general principles of section 482 of the Code, the United States competent authority will consider persons to be related persons if they are related persons within the meaning of section 482. The following examples illustrate the application of this subparagraph.

Example 1. A Netherlands company has one class of shares. Five individuals who are residents of Hong Kong each own 10 percent of the company's shares for at least 30 days during the taxable year. Since residents of Hong Kong are not qualified residents or residents of a member State of the European Communities, the company would be considered a closely held company.

Example 2. The facts are the same as in Example 1, except that all the shares of the Netherlands company are held by another Netherlands company, and the individuals each own 10 percent of the shares of the second Netherlands company. Since the definition of closely held company includes indirect ownership of shares, the company also would be considered to be a closely held company under these facts.

Example 3. The facts are the same as in Example 1, except that four residents of Hong Kong each own 12 percent of the company's shares for at least 30 days during the taxable year and a fifth resident of Hong Kong owns 4 percent of the company's shares for at least 30 days during the taxable year. No other shareholder owns more than 5 percent of the shares for any 30 day period during the taxable year. Although these individuals in the aggregate own more than 50 percent of the company's shares, the company is not a closely held company because only persons who own more than 5 percent of the shares are considered for this purpose. The individual with 4 percent of the shares therefore is disregarded, and only 48 percent of the company's ownership falls under the definition in subparagraph 8(e).

Example 4. The facts are the same as in Example 3, except that the individual with 4 percent of the shares of the company is the spouse of one of the persons holding 12 percent of the shares of the company. Applying the principles of Code section 482, it is determined that the spouses are related persons within the meaning of that provision. The company will be considered to

be a closely held company because ownership by related persons and their owners is aggregated. Therefore, three persons are considered each to own 12 percent of the shares of the company, and a fourth person is considered to own 16 percent of the shares.

Substantially and Regularly Traded - Subparagraph 8(f)

Subparagraph 8(f) provides that a class of shares will be considered to be "substantially and regularly traded" on one or more recognized stock exchanges if trades in such class are effected on one or more such exchanges in other then de minimis quantities in every month of the taxable year for which benefits of the Convention are claimed and the aggregate number of shares of that class traded on such exchanges during the previous taxable year is at least 6 percent of the average number of shares outstanding in that class during such previous year. If a company's principal class of shares (as defined in subparagraph 8(a)) consists of more than one class of shares, the classes of shares that comprise the principal class of shares are aggregated for purposes of applying this subparagraph. If, however, the company has a disproportionate class of shares (as defined in subparagraph 8(c)), this subparagraph is applied independently to the disproportionate class of shares and to the other class or classes of shares that comprise the principal class of shares. Thus, if a company's principal class of shares consists of three classes of shares, one of which is a disproportionate class of shares, this subparagraph would be applied twice: once to the disproportionate class of shares, and once to the other two classes that comprise the principal class of shares. Any pattern of trades conducted in order to meet this test will be disregarded. Thus, for example, trades between related parties that do not affect the overall control of the company or trades in which it is understood that the shares will be resold to the seller at a future date may be disregarded if such trades were undertaken with the principal purpose of creating trading volume in order to qualify for treaty benefits. Paragraph XXIV. of the Memorandum of Understanding sets forth the understanding of the negotiators that it is not necessary for a person claiming the benefits of the Convention to establish that it has not engaged in a pattern of trades designed to satisfy the requirement of this subparagraph. It may be necessary, however, for such person to rebut such evidence when presented with it by one of the competent authorities. This understanding does not affect the obligation of the taxpayer, as described in paragraph X. of the Memorandum of Understanding, to provide reasonable evidence of its entitlement to benefits under the Convention upon request. The following examples illustrate the application of this subparagraph.

Example 1. NL-1 is a corporation resident in the Netherlands. It is not a closely held company. NL-1 has one class of shares that is listed and traded on the Amsterdam Stock Exchange. In determining whether these shares meet the

substantially and regularly traded requirement of this subparagraph for the 1996 taxable year, it is established that NL-1's monthly turnover was at least 1 percent of the total outstanding shares for the 1996 taxable year, and that 20 percent of the shares outstanding during the 1996 taxable year were traded during the 1995 taxable year. NL-1 satisfies the substantially and regularly traded requirement.

Example 2. NL-2 is a corporation resident in the Netherlands. It is not a closely held company. NL-2 has three classes of shares: Common, Preferred A and Preferred B. In accordance with subparagraph 8(a), the principal class of shares of NL-2 is considered to consist of the Common and Preferred A shares. The Common and Preferred A classes must in the aggregate satisfy the substantially and regularly traded requirement under this subparagraph. The Common and Preferred A shares are listed and traded on the Amsterdam Stock Exchange. The Preferred B shares are privately held. In determining NL-2's entitlement to benefits under the Convention with respect to the 1996 taxable year, the trading records of the Common and Preferred A shares for the 1995 and 1996 taxable year are examined. These records indicate that the Common shares were substantially and regularly traded within the meaning of subparagraph 8(f). The records also indicate that less than 6 percent of the outstanding Preferred A shares were traded in 1995, but that more than 6 percent of the combined Common and Preferred A shares were traded. Although the Preferred A shares would not be considered to be substantially and regularly traded if they were analyzed in isolation, both the Common and Preferred A shares are analyzed together for purposes of this test. Therefore the principal class of shares of NL-2 will be considered to be substantially and regularly traded.

Example 3. The facts are the same as in Example 2, except that the Preferred B shares are a disproportionate class of shares, and the principal class of shares therefore includes the Preferred B shares in accordance with subparagraph 8(a). As described in Example 2, the Common and Preferred A shares are considered to be substantially and regularly traded. Since the Preferred B shares are a disproportionate class of shares, the substantially and regularly traded test under subparagraph 8(f) also must be applied to the Preferred B shares. Since the Preferred B shares are privately held, they are not considered to be substantially and regularly traded, and the principal class of shares of NL-2 is not considered to be substantially and regularly traded for purposes of subparagraph 8(f).

Example 4. The facts are the same as in Example 2, except that NL-2's shares are listed and traded on the Amsterdam Stock Exchange and the Hamburg Stock Exchange. For the 1995 taxable year, 4 percent of the outstanding Common and Preferred A shares were traded on the Amsterdam Stock Exchange, and 4 percent were traded on the Hamburg Stock Exchange. The requirement under

subparagraph 8(f)(ii) that at least 6 percent of the aggregate number of shares of the principal class of shares be traded during the preceding taxable year is satisfied. See also Example 5 under the discussion of subparagraph 1(c)(i).

Qualified Person - Subparagraph 8(g)

A qualified is person is defined in subparagraph 8(g) to mean a person entitled to the benefits of the Convention pursuant to paragraph 1 of Article 26, and a citizen of the United States. Since a company only will be considered to be a qualified person if it is entitled to the benefits of the Convention under paragraph 1 of Article 26, it will not be considered a qualified person if it is entitled to the benefits of the Convention under another paragraph of Article 26. Thus, a company qualifying for the benefits of the Convention under the headquarters company rule of paragraph 3 of Article 26 would not be considered a qualified person.

Member State of the European Communities - Subparagraph 8(h)

Subparagraph 8(h) defines the term "member state of the European Communities" to mean (unless the context requires otherwise), the Netherlands and any other member state of the European Communities with which both States have in effect a comprehensive income tax Convention. As of the date of this Explanation, the Netherlands has in effect a comprehensive income tax Convention with all the members of the European Communities, and the United States has such Conventions in effect with all members except for Portugal. Therefore, for purposes of this definition, all the members of the European Communities are included except for Portugal. This definition is ambulatory; if both States and Portugal conclude a comprehensive income tax convention, Portugal would be included within the definition. Conversely, if one of the Contracting States terminated its convention with a particular member of the EC, or a member of the EC removed itself from the EC, that state would no longer be considered a member state of the European Communities for purposes of the Convention.

This definition encompasses all parts of a state, unless the context requires otherwise. The context requires otherwise if a particular part of the territory of a particular state is not encompassed by all the provisions of the convention between a Contracting State and such third state. For instance, the Channel Islands or the Isle of Man would not be considered part of the United Kingdom for this purpose, as the United States-United Kingdom Income Tax Convention does not apply to such jurisdictions.

Resident of a Member State of the European Communities - Subparagraph 8(i)

Subparagraph 8(i) defines the term "resident of a member state of the European Communities" as a person that meets three requirements: (i) the person would be considered a resident of such member state under the principles of Article 4 (Resident) of the Convention; (ii) would be entitled to the benefits of the Convention under the principles of paragraph 1 of Article 26, applied as if such member state were the Netherlands; and (iii) such person is otherwise entitled to the benefits of the Convention between that person's state of residence and the United States.

A person will meet the first requirement if that person would satisfy the provisions of Article 4 (Resident) of the Convention if that article were applicable to the state of residence of the person. Thus, that person must be liable to tax in that state by reason of his domicile, residence, etc., as provided in Article 4.

A person will meet the second requirement if that person would be entitled to the benefits of the Convention under paragraph 1 of Article 26 if the third state were the Netherlands. Thus, a company resident in a third state would be required to qualify under subparagraph 1(c) or (d) in order satisfy this requirement. A company that only could qualify under other paragraphs of Article 26, such as the substantial business presence test of paragraph 2 or the headquarters company rule of paragraph 3, would not satisfy this requirement.

Paragraph VII. of the Agreed Minutes clarifies that a person will be considered to be "otherwise" entitled to the benefits of the Convention between that person's state of residence and the United States (the "second convention") if that person is entitled to the benefits of the second convention with respect to the items of income derived from the United States under all provisions of the second convention, with the exception of provisions relating to limitation on benefits. However, such person also must satisfy any relevant provision relating to the limitation on benefits in the second Convention if Article 26 does not contain a provision of the "same or similar nature" as a provision in the second convention. Thus, the person generally must satisfy only the provisions of the second convention other than that convention's limitation on benefits provisions. It only would be required to satisfy a provision related to limitation on benefits in the second convention if that provision contained a provision of a different nature than the provisions contained in Article 26. A provision is of the same or similar nature as one contained in Article 26 if the substance of the tests imposed is similar; i.e., a test requiring public ownership for a company would be of a similar nature to paragraph 1, and a provision requiring a substantial business presence in one of the states would be of a similar nature to paragraph 2 of Article 26. Thus, a resident of Germany would not

be required to satisfy the provisions of Article 28 of the United States-Germany income tax convention because Article 28 of that convention does not contain provisions that are of a different nature than those contained in Article 26. A provision will not be considered to be of a same or similar nature as the provisions in Article 26 if it is of a different kind than those contained in Article 26. For instance, if the limitation on benefits article of a convention between the United States and a member state of the European Communities contained a provision that denied treaty benefits to all companies of a particular type, or companies that were resident of a particular territory of that state, then such provisions would be of a different nature than the provisions of Article 26, because Article 26 does not have a provision that denies treaty benefits to a particular category of corporations or to residents of a particular territory of the Netherlands. In such a case it would be necessary for a resident of that state to satisfy that portion of the limitation on benefits article of the second convention in order to satisfy this subparagraph.

Not-for-Profit Organizations - Subparagraph 8(j)

Subparagraph 8(j) provides that the not-for-profit organizations referred to in subparagraph 1(e) include, but are not limited to, pension funds, pension trusts, private foundations, trade unions, trade associations, and similar organizations. In addition, a pension fund, trust or similar entity that is organized for the purpose of providing retirement or other employment benefits and that is organized under the laws of a State shall be entitled to the benefits of the Convention if the organization sponsoring such fund, trust or similar entity is entitled to the benefits of the Convention under Article 26. Thus, a Netherlands pension fund established by a Netherlands publicly-traded corporation that is entitled to the benefits of the Convention under paragraph 1 of Article 26 would be entitled to the benefits of the Convention without regard to whether more than half its participants are qualified persons.

Indirect Ownership - Subparagraph 8(k)

Subparagraph 8(k), as amended by Article 5 of the Protocol, provides that for purposes of the tests set forth under subparagraph 1(c)(ii) and clauses (A) and (B) of subparagraph 1(c)(iii), all companies in a chain of ownership that are used to satisfy the ownership requirements of such provision must be a resident of one of the States or a resident of a member state of the European Communities. The following examples illustrate the application of this rule.

Example 1. NL-1 is a corporation resident in the Netherlands. 100 percent of its shares are held by UKCo, a United Kingdom corporation that is a resident of a member state of the European Communities. All the shares of UKCo are owned by NL-2, a

Netherlands corporation whose shares are listed and traded as described in subparagraph 1(c)(i). NL-1 is not a conduit company as defined in subparagraph 8(m). NL-1 is entitled to the benefits of the Convention under subparagraph 1(c)(ii) because more than 50 percent of its shares are held indirectly by NL-2, a publicly-traded corporation resident in the Netherlands satisfying the publicly-traded test of subparagraph 1(c)(i). Subparagraph 8(k) permits NL-1 to trace its ownership through UKCo because UKCo is a resident of a member State of the European Communities.

Example 2. The facts are the same as in Example 1, except that 50 percent of the shares of UKCo are held by NL-2 and 50 percent by NL-3, a closely held corporation resident in the Netherlands that is owned by persons who are individual residents of a third state. Since the stock of NL-3 is not listed and traded as described in subparagraph 1(c)(i), its ownership of UKCo shares is not considered for purposes of the test set forth under subparagraph 1(c)(ii), and only 50 percent of the shares of NL-1 meet the requirements of such test (i.e., the portion of UKCo's interest in NL-1 that is attributable to NL-2). Therefore NL-1 does not satisfy the test set forth under subparagraph 1(c)(ii).

Example 3. The facts are the same as in Example 1, except that UKCo is a corporation resident in the Cayman Islands ("CaymanCo"). Since CaymanCo is not a resident of a member state of the European Communities or a resident of the United States, NL-2's indirect ownership of NL-1 through CaymanCo is not considered for purposes of the test set forth under subparagraph 1(c)(ii).

Paragraph XXV. of the Memorandum of Understanding describes situations in which a corporation resident in one of the States that is entitled to the benefits of the Convention acquires control of a corporation resident in a third state that in turn controls a second corporation resident in the first State. In such cases, the second corporation would not be entitled to the benefits of the Convention, notwithstanding its ultimate ownership by the first corporation, if the intermediate corporation resident in a third state is not a resident of a member state of the European Communities. In such cases, this paragraph provides that the competent authority of the other State, in considering a request for benefits under paragraph 7 of Article 26, will consider favorably a plan or reorganization submitted by the second corporation, if such plan would result in the second corporation being entitled to the benefits of the Convention within a reasonable transition period. The following example illustrates the intended application of paragraph XXV. of the Memorandum of Understanding.

Example. NL-1 is a corporation resident in the Netherlands. All of the shares of NL-1 are owned by CaymanCo, a corporation resident in the Cayman Islands. NL-1 is not entitled to the benefits of the Convention. NL-2, a publicly-traded corporation

resident in the Netherlands that is entitled to the benefits of the Convention under paragraph 1, acquires all the shares of CaymanCo. If NL-2 directly owned the shares of NL-1, NL-1 would be entitled to the benefits of the Convention. Since NL-2 indirectly controls NL-1 through CaymanCo, however, in accordance with subparagraph 8(k) NL-2's indirect ownership of NL-1 is disregarded for purposes of the tests set forth under subparagraph 1(c).

In connection with a request to the U.S. competent authority under paragraph 7, NL-2 submits to the United States competent authority a plan of reorganization pursuant to which the stock of NL-2 is to be distributed to NL-1 in connection with a liquidation of CaymanCo within one year of the acquisition of the shares of CaymanCo by NL-2. After the reorganization, NL-2 will be entitled to the benefits of the Convention under paragraph 1. Based on the plan of reorganization, the United States competent authority may decide to grant NL-2 the benefits of the Convention during the transitional period between the acquisition of the CaymanCo shares by NL-2 and the reorganization, taking into account the other factors listed under paragraph 7.

Newly-Established Companies, Etc. - Subparagraph 8(l)

Subparagraph 8(l) provides that for purposes of paragraphs 2, 3 and 5, the competent authorities may by mutual agreement establish transition rules for newly-established business operations, corporate groups and headquarters companies. This provision is intended to permit the competent authorities to apply the referenced provisions flexibly in cases in which the taxpayer cannot satisfy the requirements of such provisions due to the fact that their relevant operations are recently established.

Conduit Company - Subparagraph 8(m)

Subparagraph 8(m) defines the term "conduit company," which is relevant for purposes of the tests set forth under subparagraphs 1(c)(ii) and (iii). A conduit company generally is any company that makes payments of interest, royalties and any other payments included in the definition of deductible payments under subparagraph 5(c) in a taxable year in an amount equal to or greater than 90 percent of its aggregate receipts of such items during the same year. Banks and insurance companies shall not be considered to be conduit companies, however, if they are engaged in the active conduct of a banking or insurance business and are managed and controlled by associated enterprises that are qualified persons (as defined in subparagraph 8(g)). Paragraph XIII. of the Memorandum of Understanding provides that it is understood that a bank only will be considered to be engaged in the active conduct of a banking business if it regularly accepts deposits from the public or makes loans to the public, and an insurance company only will be considered to be engaged in the active conduct of an insurance business if its gross income consists primarily of insurance or

reinsurance premiums, and investment income attributable to such premiums. Whether two enterprises are associated enterprises will be determined without regard to whether they are residents of different states. The following examples illustrate the application of this subparagraph.

Example 1. NL-1 is a corporation resident in the Netherlands. NL-1 receives $100 of interest income during its 1996 taxable year. It does not receive any royalties or other deductible payments during the year. It pays $90 in interest during the same year. NL-1 is a conduit company because it made payments of items classified as deductible payments equal to at least 90 percent of its receipts of such items.

Example 2. The facts are the same as in Example 1, except that NL-1 is a bank engaged in the active conduct of a banking business, and NL-1 is managed and controlled by NL-2, a corporation entitled to the benefits of the Convention under paragraph 1. Since NL-1 is a bank engaged in the active conduct of a banking business and is managed and controlled by an associated enterprise that is a qualified person, NL-1 is not a conduit company.

Example 3. The facts are the same as in Example 1, except that in addition to its receipts of interest income, NL-1 also receives $10 in royalty income during the 1996 taxable year. It has no royalty expenses. Since the conduit company test applies only if the aggregate receipts of items classified as deductible payments are equal to or greater than 90 percent of the company's receipts of such items, NL-1's royalty and interest receipts are aggregated for purposes of subparagraph 8(m). Consequently, NL-1's payments of deductible payments ($90) are 81.8 percent of its receipts of such items (i.e., $100 in interest and $10 in royalties, or $110). NL-1 therefore is not a conduit company.

Ownership Tests - Paragraph 1

Paragraph 1 provides that a resident of one of the States that derives income from the other State will be entitled to all the benefits of the Convention if that person is described in subparagraphs 1(a), (b), (c), (d), or (e). First, subparagraph 1(a) provides that an individual resident of one of the Contracting States will be entitled to treaty benefits. For this purpose, residence is determined under Article 4 (Resident). Second, subparagraph 1(b) extends treaty benefits to a State, or a political subdivision or local authority thereof. It is unlikely that persons falling into either of these categories can be used to exploit the Convention by deriving income from the other State on behalf of a third-country person. If an individual receives income as a nominee of a person not entitled to treaty benefits, the benefits of the Convention will be denied with respect to such income under the articles of the Convention that grant the benefit, as those articles require that the beneficial owner of the income

be a resident of a Contracting State.

Subparagraph 1(c) provides four alternative tests under which a company may be entitled to the benefits of the Convention. These tests relate to certain publicly-traded corporations, subsidiaries of publicly-traded corporations, certain Netherlands corporations with specified Dutch and EC ownership, and "conduit companies" (as defined in subparagraph 8(m)). These tests are described below.

Publicly-Traded Corporations - Subparagraph 1(c)(i)

First, subparagraph 1(c)(i) provides that a company will be entitled to the benefits of the Convention if the "principal class of its shares" is listed on a "recognized stock exchange" in either of the States and the shares of that class are "substantially and regularly traded" on one or more recognized stock exchanges. As discussed above, the term "principal class of shares" is defined in subparagraph 8(a), the term "recognized stock exchange" is defined in subparagraph 8(d), and the term "substantially and regularly traded" is defined in subparagraph 8(f). The following examples illustrate the application of this subparagraph.

Example 1. NLCo is a corporation resident in the Netherlands. NLCo has one class of shares that is listed and traded on the Amsterdam Stock Exchange. The shares of NLCo are traded in more than de minimis amounts in every month of the 1997 taxable year. In addition, the aggregate number of NLCo shares traded during the preceding taxable year (1996) exceeded 6 percent of the average number of outstanding shares during 1996. NLCo is entitled to the benefits of the Convention under subparagraph 1(c)(i).

Example 2. The facts are the same as in Example 1, except that NLCo's shares are listed on the parallel market of the Amsterdam Stock Exchange and a second, non-Dutch and non-U.S. stock exchange described in Paragraph VI. of the Agreed Minutes to the Protocol, as authorized by subparagraph 8(d)(iv). NLCo is not a closely held company as defined in subparagraph 8(e). NLCo shares are not traded in substantial volume on the parallel market of the Amsterdam Stock Exchange, but they are substantially and regularly traded on the second stock exchange. NLCo is entitled to the benefits of the Convention under subparagraph 1(c)(i). Although its shares are not substantially and regularly traded on the parallel market of the Amsterdam Stock Exchange, subparagraph 1(c)(i) only requires that the principal class of NLCo's shares be listed on a recognized exchange in either of the States. The shares also must be substantially and regularly traded, but this requirement may be satisfied through substantial and regular trading on any recognized stock exchange, including the stock exchanges described under subparagraph 8(d)(iv).

Example 3. The facts are the same as in Example 2, except

that NLCo is a closely held company as defined in subparagraph 8(e). NLCo is not entitled to the benefits of the Convention under subparagraph 1(c)(i). Subparagraph 8(d) provides that with respect to a closely held company, the term "recognized stock exchange" does not include the stock exchanges mentioned under subparagraph 8(d)(iii), which includes the parallel market of the Amsterdam Stock Exchange. Therefore, for purposes of subparagraph 1(c)(i), the shares of NLCo are not considered to be listed on a recognized stock exchange located in either of the States.

Example 4. USCo is a corporation resident in the United States. USCo has two classes of shares: Common and Alphabet. The Common shares are listed on the New York Stock Exchange and are substantially and regularly traded. The Common shares account for all the voting power of USCo and more than 50 percent of its value. The Alphabet shares entitle the owner to receive the profits attributable to USCo's income from Netherlands sources. The Alphabet shares are owned by an individual resident in a third state. The Alphabet shares constitute a disproportionate class of shares within the meaning of subparagraph 8(c).

In general, subparagraph 8(a) provides that the principal class of shares includes those shares that account for more than 50 percent of the vote and value of the company. Notwithstanding this general rule, any disproportionate class of shares also is treated as belonging to the principal class of shares. Therefore, for purposes of subparagraph 1(c)(i), the principal class of shares includes a disproportionate class of shares even if other classes of shares account for more than 50 percent of the vote and value of the company.

Consequently, in this example the principal class of shares of USCo includes both the Common and Alphabet shares. Each class must satisfy the tests set forth under subparagraph 1(c)(i) in order for the company to be entitled to the benefits of the Convention under that provision. Since the Alphabet shares are not publicly-traded, USCo is not entitled to the benefits of the Convention under subparagraph 1(c)(i).

Example 5. NLCo is a corporation resident in the Netherlands. It is not a closely held company. NL-2 has three classes of shares: Common, Preferred A and Preferred B. In accordance with subparagraph 8(a), the principal class of shares of NLCo is considered to consist of the Common and Preferred A shares. The Common shares are listed and traded on the Amsterdam Stock Exchange. The Preferred A shares are listed and traded on the Hamburg Stock Exchange. The combined shares of the Common and Preferred A classes would satisfy the volume requirements under subparagraph 8(f) and therefore would be considered to be substantially and regularly traded. Since, however, the principal class of the shares of NLCo consists of both the Common and Preferred A shares, both classes must be listed on a recognized

stock exchange located in either State. Since the Preferred A shares are not listed on a recognized stock exchange located in either State, NLCo is not entitled to the benefits of the Convention under subparagraph 1(c)(i).

Subsidiaries of Publicly-Traded Corporations - Subparagraph 1(c)(ii)

Subparagraph 1(c)(ii) provides a test under which certain companies that are directly or indirectly controlled by companies satisfying the publicly-traded test of subparagraph 1(c)(i) may be entitled to the benefits of the Convention. Under this test, a company will be entitled to the benefits of the Convention if more than 50 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies that are resident of either State, the principal classes of the shares of which are listed and traded as described in subparagraph 1(c)(i). In addition, the company may not be a conduit company (as defined in subparagraph 8(m)).

Under this test, more than 50 percent of the vote and value of all of the company's shares, not merely its principal class of shares, must be held by Dutch or U.S. publicly-traded companies. For this purpose, "value" is fair market value. Authorized but unissued shares are not considered for purposes of this test.

Subject to the limitations imposed by subparagraph 8(k), ownership may be indirect. Thus, ownership may be traced through intermediate companies to an ultimate owner that is a publicly-traded Netherlands or United States corporation, as long as the intermediate companies are residents of the United States or a member state of the European Communities. Share ownership will be determined under the principles of section 883(c)(4) of the Code. The following examples illustrate the application of this subparagraph.

Example 1. NL-1 is a corporation resident in the Netherlands. It has one class of shares. All of the outstanding shares of NL-1 are owned by NL-2, a corporation resident in the Netherlands. The principal class of the shares of NL-2 is listed and traded as described in subparagraph 1(c)(i). NL-1 is not a conduit company. NL-1 is entitled to the benefits of the Convention under subparagraph 1(c)(ii) because more than 50 percent of the vote and value of its shares are owned by a company resident in the Netherlands, and the principal class of the shares of that company is listed and traded as described in subparagraph 1(c)(i).

Example 2. The facts are the same as in Example 1, except that NL-1 is a conduit company as defined in subparagraph 8(m). NL-1 is not entitled to the benefits of the Convention under subparagraph 1(c)(ii), because clause (B) of that subparagraph provides that subparagraph 1(c)(ii) does not apply to conduit

companies. NL-1 may, however, be entitled to the benefits of the Convention under subparagraph 1(c)(iv).

Example 3. The facts are the same as in Example 1, except that the shares of NL-1 are held by USCo, a corporation resident in the United States. The principal class of the shares of USCo is listed and traded as described in subparagraph 1(c)(i). Since subparagraph 1(c)(ii) provides that the ultimate owner of the shares of the company seeking the benefits of the Convention may be a company that is a resident of either State, NL-1 is entitled to the benefits of the Convention under subparagraph 1(c)(ii).

Example 4. US-1 is a corporation resident in the United States. It has one class of shares. 50 percent of the shares of US-1 are owned by an individual who is a resident of the United States, and 50 percent are owned by US-2, a corporation resident in the United States. The principal class of the shares of US-2 is listed and traded as described in subparagraph 1(c)(i). US-1 is not a conduit company. US-1 is not entitled to the benefits of the Convention under subparagraph 1(c)(ii) (although it may be entitled to the benefits of the Convention under subparagraph 1(d)). Subparagraph 1(c)(ii) requires that more than 50 percent of the shares of the company seeking the benefits of the Convention be owned by publicly-traded companies resident in either State. Since 50 percent of the shares of US-1 are owned by an individual, the test of this subparagraph is not satisfied, despite the fact that the individual is a resident of the United States.

Example 5. NLSub is a corporation resident in the Netherlands. It has one class of shares. All of the outstanding shares of NLSub are owned by NLHolding, also a corporation resident in the Netherlands. NLHolding has one class of shares. 40 percent of the shares of NLHolding are owned by NLParent, a corporation resident in the Netherlands. The principal class of the shares of NLParent is listed and traded as described in subparagraph 1(c)(i). 60 percent of the shares of NLHolding are owned by UKCo, a corporation resident in the United Kingdom. UKCo is entitled to the benefits of the Convention between the United States and the United Kingdom. 40 percent of the shares of UKCo are owned by HKCo, a corporation resident in Hong Kong, and 60 percent are owned by USCo, a corporation resident in the United States. The principal class of the shares of USCo is listed and traded as described in subparagraph 1(c)(i). Because more than 50 percent of its shares are owned by USCo, a resident of one of the States, and the principal class of USCo's shares is listed and traded as described in subparagraph 1(c)(i), UKCo would be entitled to the benefits of the Convention under subparagraph 1(c)(ii), applied as if the United Kingdom were the Netherlands. Neither NLSub, NLHolding nor UKCo is a conduit company as defined in subparagraph 8(m).

The ownership of NLSub's shares for purposes of subparagraph

1(c)(ii) is analyzed as follows. The immediate shareholder of NLSub is NLHolding. The shares of NLHolding are not publicly traded, so its ownership of NLSub does not entitle NLSub to the benefits of the Convention under subparagraph 1(c)(ii). Forty percent of the shares of NLHolding are owned by NLParent. Since NLParent meets the requirements of subparagraph 1(c)(i), and NLHolding is a resident of a member state of the European Communities (as required by subparagraph 8(k)), the NLSub shares attributable to NLParent's shares in NLHolding are counted for purposes of meeting the 50 percent ownership requirement in subparagraph 1(c)(ii). Since NLParent owns 40 percent of the shares of NLHolding, 40 percent of the shares of NLSub are attributable to NLParent.

The remaining shares of NLHolding (60 percent) are owned by UKCo. UKCo is not a resident of one of the States and it is not publicly-traded. UKCo therefore is not a qualified shareholder for purposes of subparagraph 1(c)(ii). Subparagraph 8(k) provides that indirect ownership through residents of member states of the European Communities may be taken into account under subparagraph 1(c)(ii). Subparagraph 8(i) provides that a company will be considered a resident of a member state of the European Communities if it is a resident of its state of residence within the meaning of Article 4, it would be entitled to the benefits of the Convention under paragraph 1 if its state of residence were the Netherlands, and it is otherwise entitled to the benefits of the convention between its state of residence and the United States. Since all of these conditions are satisfied, UKCo is considered to be a resident of a member state of the European Communities, and indirect ownership of NLHolding shares through UKCo will be considered for purposes of the analysis under subparagraph 1(c)(ii).

Since HKCo is not a resident of a member state of the European Communities nor a resident of one of the states, the NLHolding shares that are attributable to HKCo's shares in UKCo are disregarded for purposes of the analysis under subparagraph 1(c)(ii). USCo, however, is a resident of one of the States and its principal class of shares is listed and traded as described in subparagraph 1(c)(i). Consequently, the NLSub shares that are attributable to USCo's shares in UKCo are considered for purposes of this analysis. Since USCo owns 60 percent of the shares of UKCo, UKCo owns 60 percent of the shares of NLHolding, and NLHolding owns 100 percent of the shares of NLSub, 36 percent of the shares of NLSub are attributed to USCo for purposes of subparagraph 1(c)(ii) (i.e., 60% X 60% X 100%), in accordance with the principles of Code section 883(c)(4).

The shares of NLSub that are attributable to USCo (36 percent) and the shares of NLSub that are attributable to NLParent (40 percent) are combined for purposes of subparagraph 1(c)(ii). Accordingly, 76 percent of the shares of NLSub are considered to be owned indirectly by two companies that are resident of either

State, and the principal classes of the shares of those companies are listed and traded as described in subparagraph 1(c)(i). Furthermore, NLSub is not a conduit company. Therefore, under subparagraph 1(c)(ii), NLSub is entitled to the benefits of the Convention.

Example 6. USSub is a corporation resident in the United States. USSub has two classes of shares: Common and Preferred. The Preferred shares do not have voting rights. The total fair market value of the Common shares is equal to the fair market value of the Preferred shares. USSub is not a conduit company. Sixty percent of the Common shares and 40 percent of the Preferred shares are owned by USParent, a corporation resident in the United States. The principal class of the shares of USParent is listed and traded as described in subparagraph 1(c)(i). The remaining USSub shares (60 percent of the Preferred shares and 40 percent of the Common shares) are owned by CaymanCo, a corporation resident in the Cayman Islands. Since CaymanCo is not a resident of either State and is not a resident of a member state of the European Communities, only the shares owned by USParent are considered for purposes of subparagraph 1(c)(ii). Since USParent owns 60 percent of the Common shares, and the Preferred shares do not have voting rights, USParent is considered to control 60 percent of the voting power with respect to the shares of USSub. USParent, however, only owns 50 percent of the value of such shares, since it owns only 40 percent of the Preferred shares and the Preferred and Common classes of shares have equal value.

Since subparagraph 1(c)(ii) requires that more than 50 percent of the vote and value of all the shares of the company seeking the benefits of the Convention be owned by companies that are resident of either State and the principal classes of the shares of which are listed and traded as described in subparagraph 1(c)(i), USSub is not entitled to the benefits of the Convention under subparagraph 1(c)(ii).

30/70 Netherlands/EC Ownership - Subparagraph 1(c)(iii)

Subparagraph 1(c)(iii) sets forth a special test for certain corporations resident in the Netherlands. Under this test, a Netherlands corporation will be entitled to the benefits of the Convention if at least 30 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies that are resident of the Netherlands, the principal classes of the shares of which are listed and traded as described in subparagraph 1(c)(i), and at least 70 percent of the aggregate vote and value of all of its shares is owned, directly or indirectly, by five or fewer companies that are resident of the United States or of member states of the European Communities, the principal classes of the shares of which are substantially and regularly traded on one or more recognized stock exchanges. In addition, the company may not be a conduit company (as defined in

subparagraph 8(m)).

This test is similar to the test under subparagraph 1(c)(ii) in that it entitles corporations to the benefits of the Convention if they are subsidiaries of publicly-traded companies. The principal differences from the test under subparagraph 1(c)(ii) are that this test applies only to Netherlands companies, and that it looks to ownership in the prescribed percentages by Netherlands owners and European Community owners. In addition, unlike the subparagraph 1(c)(i) test that is applied to a 30 percent Netherlands owner, the shares of a 70 percent EC owner only must be listed and traded on a recognized stock exchange rather than a recognized stock exchange located in either State. This departure from the general subparagraph 1(c)(i) publicly-traded test for EC companies recognizes the fact that many such companies only will be listed and traded in exchanges in their home countries. In other respects this test generally tracks the test set forth in subparagraph 1(c)(ii). The following examples illustrate the application of this subparagraph.

Example 1. NLSub is a corporation resident in the Netherlands. NLSub has one class of shares. NLSub is not a conduit company. 32 percent of the shares are owned by NLParent, a corporation resident in the Netherlands. The principal class of shares of NLParent is listed and traded as described in subparagraph 1(c)(i). 43 percent of the shares of NLSub are owned by UKParent, a corporation resident in the United Kingdom. The principal class of the shares of UKParent is listed on the London Stock Exchange and substantially and regularly traded as defined in subparagraph 8(f). UKParent is entitled to the benefits of the income tax convention between the United States and the United Kingdom, and would be entitled to the benefits of the Convention under subparagraph 1(c)(i), applied as if the United Kingdom were the Netherlands. The remaining 25 percent of the shares of NLSub are owned by X, an individual.

NLSub is not entitled to the benefits of the Convention under subparagraph 1(c)(ii) because only 32 percent of its shares are owned directly or indirectly by publicly-traded corporations resident of either State. NLSub is, however, entitled to the benefits of the Convention under subparagraph 1(c)(iii). Since NLParent owns 32 percent of the shares of NLSub, the 30 percent Netherlands ownership requirement under clause (A) of subparagraph 1(c)(iii) is satisfied. In addition, the 70 percent EC ownership requirement under clause (B) of subparagraph 1(c)(iii) also is satisfied, because NLParent's 30 percent ownership is aggregated with UKParent's 43 percent ownership. Consequently, 75 percent of the shares of NLSub are owned by residents of member states of the European Communities.

Example 2. The facts are the same as in Example 1, except that the shares of UKParent are not publicly-traded. Rather, 75

percent of the shares of UKParent are owned by UKHolding, a corporation resident in the United Kingdom. UKParent is not a conduit company as defined in subparagraph 8(m). The principal class of shares of UKHolding is listed on the London Stock Exchange and substantially and regularly traded as defined in subparagraph 8(f). UKHolding would be entitled to the benefits of the Convention under subparagraph 1(c)(i), applied as if the United Kingdom were the Netherlands. The remaining 25 percent of the shares of UKParent are owned by NLHolding, a corporation resident in the Netherlands. The principal class of the shares of NLHolding is listed on the Amsterdam Stock Exchange and substantially and regularly traded as defined in subparagraph 8(f). NLHolding is entitled to the benefits of the Convention under subparagraph 1(c)(i).

As in Example 1, NLSub is not entitled to the benefits of the Convention under subparagraph 1(c)(ii) because less than 50 percent of its shares are owned directly or indirectly by publicly-traded corporations resident in either State. NLSub will, however, be entitled to the benefits of the Convention under subparagraph 1(c)(iii), if UKParent is considered to be a resident of a member state of the European Communities within the meaning of subparagraph 8(i). If UKParent is considered to be a resident of a member state of the European Communities, 43 percent of the shares of NLSub will be considered to be owned directly and indirectly by Netherlands corporations (applying the principles of Code section 883(c)(4)) that meet the requirements of subparagraph 1(c)(i), thereby satisfying the 30 percent Netherlands ownership requirement of clause (A) of subparagraph 1(c)(iii) (i.e., NLParent's 32 percent direct interest plus NLHolding's 11 percent indirect interest). In addition, if UKParent is considered to be a resident of a member state of the European Communities, 32 percent of the shares of NLSub will be considered to be owned indirectly by a corporation (UKHolding) the principal class of the shares of which is listed on a recognized stock exchange and is substantially and regularly traded. Combined with the 43 percent interest held by the two Netherlands corporations, 75 percent of the shares of NLSub would be considered to be held directly or indirectly by companies described in clause (B) of subparagraph 1(c)(iii), satisfying the 70 percent threshold described in that subparagraph.

In order to be considered a resident of a member state of the European Communities, UKParent must meet the three requirements under subparagraph 8(i). Since it is assumed that UKParent is a resident of its state of residence within the meaning of Article 4 (Resident) of the Convention, and that UKParent would otherwise be entitled to the benefits of the convention between the United States and the United Kingdom, two of these requirements are clearly satisfied. The remaining requirement is that UKParent must be entitled to the benefits of the Convention under the principles of paragraph 1, applied as if the United Kingdom were the

Netherlands. Therefore it is necessary to apply paragraph 1 to UKParent, treating the United Kingdom as if it were the Netherlands.

Under this analysis, UKParent would not be entitled to the benefits of the Convention under subparagraph 1(c)(i), as its shares are not publicly-traded. It would be entitled to the benefits of the Convention under subparagraph 1(c)(ii), however, because more than 50 percent of its shares are held by a corporation (UKHolding) whose shares are listed and traded as described in subparagraph 1(c)(i). Since the United Kingdom is treated as if it were the Netherlands for purposes of this analysis, UKHolding is treated as if it were a Netherlands corporation, and the stock exchange on which its shares are listed (London) is treated as if it were a recognized stock exchange located in the Netherlands. In addition, the shares held by NLHolding also would be included, because the shares of NLHolding also are listed and traded as described in subparagraph 1(c)(i). While the United Kingdom is treated as if it were the Netherlands for purposes of this analysis, the Netherlands is not treated as if it were a state other than the Netherlands. Thus, solely for purposes of subparagraph 8(i), 100 percent of UKParent's shares are treated as if they were owned by residents of the Netherlands, the principal class of the shares of which are listed and traded as described in subparagraph 1(c)(i). Therefore, for purposes of subparagraph 8(i), UKParent is treated as if it were entitled to the benefits of the Convention under subparagraph 1(c)(ii).

Accordingly, UKParent satisfies all three requirements of subparagraph 8(i) and is considered to be a resident of a member state of the European Communities. The NLSub shares held indirectly by the shareholders of UKParent therefore are included in the shares meeting the requirements of clause (B) of subparagraph 1(c)(iii), and NLSub is entitled to the benefits of the Convention under subparagraph 1(c)(iii).

Example 3. The facts are the same as is Example 2, except that UKHolding is a corporation resident in Italy (ItaliaCo). ItaliaCo has one class of shares that is listed on the Milan Stock Exchange and is substantially and regularly traded. ItaliaCo is entitled to the benefits of the income tax convention between the United States and Italy.

As in Example 2, NLSub is not entitled to the benefits of the Convention under subparagraph 1(c)(ii) because less than 50 percent of its shares are owned directly or indirectly by publicly-traded corporations resident of either State. It would be entitled to the benefits of the Convention, however, if the indirect ownership of its shares by NLHolding and ItaliaCo were included in the shares meeting the requirements of clause (B) of subparagraph 1(c)(iii). In order for this indirect ownership through UKParent to be considered in the analysis, UKHolding must be considered to be a

resident of a member state of the European Communities under subparagraph 8(i).

In order to be considered a resident of a member state of the European Communities, UKParent must, inter alia, be entitled to the benefits of the Convention under paragraph 1, applied as if the United Kingdom were the Netherlands. Under this assumption, UKParent would not be entitled to the benefits of the Convention under subparagraph 1(c)(i), as its shares are not publicly-traded. Unlike Example 2, subparagraph 1(c)(ii) also would not apply, as only 25 percent of UKParent's shares would be held by corporations resident in the Netherlands or the United Kingdom (i.e., the shares held by NLHolding). It would not qualify under subparagraph 1(c)(iii), because clause (A) of that subparagraph requires that at least 30 percent of the shares of the company be owned by a publicly-traded Netherlands corporation. Finally, subparagraph 1(d) would not apply because, inter alia, more than 50 percent of its shares must be held by qualified persons (i.e., residents of either State) in order for that provision to apply.

Therefore UKParent is not considered to be a resident of a member state of the European Communities, and pursuant to subparagraph 8(k) the shares of NLSub that are attributable to ItaliaCo and NLHolding are not considered for purposes of determining whether NLSub is entitled to the benefits of the Convention under subparagraph 1(c)(iii). Accordingly, only 32 percent of NLSub's shares are treated as being owned by residents of member states of the European Communities (i.e., the shares owned by NLParent), and NLSub does not satisfy the 70 percent EC ownership requirement under clause (B) of subparagraph 1(c)(iii). NLSub is not entitled to the benefits of the Convention under subparagraph 1(c)(iii). However, as described in Example 3 under the explanation of paragraph 4, NLSub may be entitled under paragraph 4 to the benefits of the Convention with respect to certain items of income. Further, as with any resident of one of the States that does not satisfy one of the tests under Article 26, NLSub may be entitled to the benefits of the Convention under paragraph 7.

Example 4. The facts are the same as in Example 1, except that NLParent is a closely held corporation and its shares are listed and traded on the parallel market of the Amsterdam Stock Exchange.

NLSub is not entitled to the benefits of the Convention under subparagraph 1(c)(iii) because it does not meet the 30 percent Netherlands ownership requirement under clause (A) of that subparagraph. Clause (A) requires that the principal class of the shares of the Netherlands owner be listed and traded as described in subparagraph 1(c)(i). Subparagraph 1(c)(i) requires, inter alia, that the principal class of shares of such corporation be listed on a recognized stock exchange located in either of the

States. While subparagraph 8(d)(iii) provides that the parallel market of the Amsterdam Stock Exchange generally will be considered to be a recognized stock exchange, that provision also states that the exchanges listed in subparagraph 8(d)(iii) shall not be considered recognized stock exchanges with respect to closely held companies. Accordingly, the principal class of the shares of NLParent is not considered to be listed and traded as described in subparagraph 1(c)(i), and NLParent's ownership of NLSub shares does not satisfy the 30 percent Netherlands ownership requirement under clause (A) of subparagraph 1(c)(iii).

Conduit Companies - Subparagraph 1(c)(iv)

Subparagraph 1(c)(iv) provides that corporations that otherwise would be entitled to the benefits of the Convention under subparagraphs 1(c)(ii) or (iii) but that are conduit companies (as defined in subparagraph 8(m)) only may be entitled to the benefits of the Convention under paragraph 1(c) if they also satisfy the conduit base erosion test set forth in subparagraph 5(d). This test is described in the discussion below regarding paragraph 5 of Article 26.

50% Qualified Ownership/Base Erosion - Subparagraph 1(d)

Subparagraph 1(d) sets forth a test under which companies and other persons may be entitled to the benefits of the Convention. This test consists of two parts. First, more than 50 percent of the beneficial ownership of the person must be owned, directly or indirectly, by "qualified persons," as defined in subparagraph 8(g). In the case of a company, more than 50 percent of the aggregate vote and value of all the company's shares, and more than 50 percent of any "disproportionate class of shares" (as defined in subparagraph 8(c)), must be owned by qualified persons. Second, the company must meet the base reduction test described in paragraph 5. The beneficial ownership test of this subparagraph is discussed below. The base reduction test is described in the discussion below regarding paragraph 5.

Indirect ownership by qualified persons is considered for purposes of this test. For purposes of determining share ownership, the rules of Code section 883(c)(4) shall be applied. Subparagraph 8(k), which requires that all the members of a corporate chain of ownership be residents of one of the States or residents of a member state of the European Communities, does not apply to subparagraph 1(d). Consequently, intermediate owners may be residents of countries that are not described in subparagraph 8(k), as long as more than 50 percent of ultimate ownership resides in qualified persons (i.e., a person entitled to the benefits of the Convention pursuant to paragraph 1 or a U.S. citizen), and the person seeking treaty benefits satisfies the base reduction test. The following examples illustrate the application of subparagraph 1(d)(i).

Example 1. NLSub is a corporation resident in the Netherlands. NLSub satisfies the base reduction test of paragraph 5(d). NLSub has one class of shares. 30 percent of its shares are owned by an individual resident in the Netherlands, 40 percent are owned by NLHolding, a corporation resident in the Netherlands the principal class of the shares of which is listed and traded as described in subparagraph 1(c)(i), and 30 percent are owned by NLHQ, a corporation resident in the Netherlands that is not entitled to the benefits of the Convention under paragraph 1 but that is entitled to the benefits of the Convention under paragraph 3 of Article 26 as a headquarter company.

NLSub's entitlement to the benefits of the Convention under subparagraph 1(d) is analyzed as follows. The shares owned by NLHolding are considered because NLHolding is entitled to the benefits of the Convention under subparagraph 1(c)(i). The shares owned by NLHQ are not considered because NLHQ is not entitled to the benefits of the Convention under paragraph 1. The shares owned by the individual are considered because an individual resident in the Netherlands is entitled to the benefits of the Convention under subparagraph 1(a). Therefore, NLSub is entitled to the benefits of the Convention under subparagraph 1(d) because 70 percent of its shares are owned by qualified persons (i.e., the individual's 30 percent and NLHolding's 40 percent).

Example 2. USSub is a corporation resident in the United States. USSub satisfies the base reduction test under subparagraph 5(d). All of the shares of USSub are owned by HKCo, a corporation resident in Hong Kong. All of the shares of HKCo are owned by NLParent, a corporation resident in the Netherlands, the principal class of the shares of which is listed and traded as described in subparagraph 1(c)(i).

USSub is entitled to the benefits of the Convention under subparagraph 1(d). Although HKCo is not a qualified person, the ownership test of subparagraph 1(d) merely requires that more than 50 percent of the ultimate beneficial ownership of the person seeking the benefits of the Convention reside in persons entitled to the benefits of the Convention under paragraph 1. Since the indirect owner of USSub (NLParent) is a person entitled to the benefits of the Convention under subparagraph 1(c)(i), this requirement is satisfied.

Paragraph XI. of the Memorandum of Understanding sets forth the understanding of the negotiators that a Dutch investment company ("beleggingsinstelling") may satisfy the 50 percent qualified person ownership requirement under this subparagraph by relying on the so-called "global method" of determining ownership that is used for purposes of obtaining a refund with respect to foreign withholding taxes on dividend and interest income received from abroad. Domestic shareholders would, if the income accrued directly to them, be entitled to a credit for those taxes, but

foreign shareholders would not, as they are not subject to Netherlands tax. Since foreign tax is initially withheld on the entire amount of the beleggingsinstelling's interest and dividend income, and under Dutch law the foreign tax cannot be credited at the level of the beleggingsinstelling, the beleggingsinstelling may apply for a refund of that portion of the withheld taxes that is attributable to domestic owners, and therefore the company must demonstrate the extent of its domestic ownership to the satisfaction of the Dutch tax authority. Since it is in the interest of the beleggingsinstelling to identify its domestic shareholders to the Dutch tax authority, the negotiators felt it generally appropriate for the U.S. competent authority to rely on such evidence as was relied upon by the Dutch tax authority.

Not-For-Profit Organizations - Subparagraph 1(e)

Subparagraph 1(e) provides that a not-for-profit organization that is a resident of a Contracting State will be entitled to the benefits of the Convention if it satisfies two conditions: (1) It must be generally exempt from tax in its State of residence by virtue of its not-for-profit status, and (2) more than half of the beneficiaries, members or participants, if any, in the organization must be "qualified persons" as defined in subparagraph 8(g). Subparagraph 8(j) provides that the not-for-profit organizations dealt with in subparagraph 1(e) include pension funds, pension trusts, private foundations, trade unions, trade associations and similar organizations. A pension fund or trust or similar entity created for the purpose of providing retirement, disability or other employment benefits is entitled to the benefits of the Convention if the organization sponsoring the fund, trust or entity is entitled to the Convention's benefits under Article 26. Thus, one need not determine that more than half of the beneficiaries of a Netherlands pension plan are residents of the Netherlands in deciding whether the plan is entitled to the benefits of the Convention in respect of its income as long as the Netherlands corporation sponsoring the fund is entitled to benefits under Article 26, because, for example, its principal class of shares is listed on the Amsterdam Stock Exchange and is substantially and regularly traded, thereby entitling it to the benefits of the Convention under subparagraph 1(c)(i). If, however, the sponsoring organization is not entitled to the benefits of the Convention, the tests of subparagraph 1(e) must be met.

Substantial Trade or Business Test - Paragraph 2

Paragraph 2 provides that a person resident in one of the States may be entitled to the benefits of the Convention with respect to income derived from the other State if it is considered to be engaged in the active conduct of a trade or business in its State of residence. Subparagraph 2(a) provides that such a person will be entitled to the benefits of the Convention with respect to an item of income derived from the other State if the income is

derived in connection with the trade or business conducted in the State of residence and the trade or business is substantial in relation to the income producing activity, or the income derived in the other State is incidental to the trade or business conducted in the State of residence. This determination is made separately for each item of income derived from the other State. It therefore is possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. For instance, dividends received from a subsidiary in the other State might be entitled to the benefits of the Convention, but interest received from an unrelated party might not be so entitled.

Trade or Business

The term "trade or business" is not defined in the Convention. Pursuant to paragraph 2 of Article 3 (General Definitions), when determining whether a Netherlands resident is entitled to the benefits of the Convention under paragraph 2 with respect to income derived from U.S. sources, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the United States competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation will generally be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities. See, Code section 367(a)(3) and the regulations thereunder.

Notwithstanding this general definition of trade or business, subparagraph 2(a) provides that the business of making or managing investments, when part of banking or insurance activities conducted by a bank or insurance company, respectively, will be considered to be a trade or business. Conversely, such activities conducted by an entity other than a bank or insurance company will not be considered to be the conduct of an active trade or business. Paragraph XIII. of the Memorandum of Understanding sets forth the understanding of the negotiators that a bank only will be considered to be engaged in the active conduct of a banking business if it regularly accepts deposits from the public or makes loans to the public, and an insurance company only will be considered to be engaged in the active conduct of an insurance business if its gross income consists primarily of insurance or reinsurance premiums, and investment income attributable to such premiums. Paragraph III. of the Agreed Minutes to the Protocol clarifies the understanding of the negotiators that group financing or portfolio investments will be considered to be part of a business of making or managing investments. Accordingly, such

activities will not be considered to be a trade or business, unless they fall within the banking or insurance exception described in subparagraph 2(a).

Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarter company will not be considered to be engaged in an active trade or business for purposes of paragraph 2. Such companies may, however, be entitled to the benefits of the Convention under paragraph 3.

In order for a person to be entitled under subparagraph 2 to the benefits of the Convention with respect to an item of income, that income must be derived in connection with the trade or business conducted in the State of residence or be incidental to such trade or business. An item of income may be derived partly in connection with a trade or business conducted in the State of residence and partly not in connection with such trade or business. Furthermore, subparagraph 2(a)(i) provides that income derived in connection with a trade or business must also be "substantial" in relation to the income-producing activity conducted in the other State.

Derived in Connection With Requirement - Subparagraph 2(b)

Subparagraph 2(b) provides that income is derived in connection with a trade or business if the income-producing activity in the other State is a line of business that forms a part of or is complementary to the trade or business conducted in the State of residence by the income recipient. Although no definition of the terms "forms a part of" or "complementary" is set forth in the Convention, it is intended that a business activity generally will be considered to "form a part of" a business activity conducted in the other State if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. In order for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. In cases in which more than one trade or business is conducted in the other State and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the State of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends will be deemed to be derived first out of earnings and profits of the treaty-benefitted trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S.

principles for expense allocation will be considered a reasonable method. The following examples illustrate the application of subparagraph 2(b).

Example 1. NLCo is a corporation resident in the Netherlands. NLCo is engaged in an active manufacturing business in the Netherlands. NLCo owns 100 percent of the shares of USCo, a corporation resident in the United States. USCo is the United States distributor for NLCo products. Since the business activities conducted by the two corporations involve the same products, USCo's distribution business is considered to form a part of NLCo's manufacturing business within the meaning of subparagraph 2(b).

Example 2. The facts are the same as in Example 1, except that NLCo does not manufacture. Rather, NLCo operates a large research and development facility in the Netherlands that licenses intellectual property to affiliates worldwide, including USCo. USCo and other NLCo affiliates then manufacture and market the NLCo-designed products in their respective markets. Since the activities conducted by NLCo and USCo involve the same product lines, these activities are considered to form a part of the same trade or business.

Example 3. NLAir is a corporation resident in the Netherlands. NLAir operates an international airline. USSub is a wholly-owned U.S. subsidiary of NLAir. USSub operates a chain of hotels in the United States that are located near airports served by NLAir flights. NLAir frequently sells tour packages that include air travel to the United States and lodging at USSub hotels. Although both companies are engaged in the active conduct of a trade or business, the businesses of operating a chain of hotels and operating an airline are distinct trades or businesses. Therefore USSub's business does not form a part of NLAir's business. However, USSub's business is considered to be complementary to NLAir's business because they are part of the same overall industry (travel) and the links between their operations tend to make them interdependent.

Example 4. The facts are the same as in Example 3, except that USSub owns an office building in the United States instead of a hotel chain. No part of NLAir's business is conducted through the office building. USSub's business is not considered to form a part of or to be complementary to NLAir's business. They are engaged in distinct trades or businesses in separate industries, and there is no economic dependence between the two operations.

Example 5. NLBulb is a corporation resident in the Netherlands. NLBulb produces and sells tulip bulbs in the Netherlands and other countries. NLBulb owns all the shares of USHolding, a corporation resident in the United States. USHolding is a holding company that is not engaged in a trade or business.

USHolding owns all the shares of three corporations that are resident in the United States: USBulb, USLawn, and USHerring. USBulb distributes NLBulb tulip bulbs under the NLBulb trademark in the United States. USLawn markets a line of lawn care products in the United States under the NLBulb trademark. In addition to being sold under the same trademark, USLawn and USBulb products are sold in the same stores and sales of each company's products tend to generate increased sales of the other's products. USHerring imports herring from the Netherlands and distributes it to United States fish wholesalers. For purposes of paragraph 2, the business of USBulb forms a part of the business of NLBulb, the business of USLawn is complementary to the business of NLBulb, and the business of USHerring is neither part of nor complementary to that of NLBulb.

USBulb and USLawn pay an annual royalty to NLBulb for the use of the NLBulb trademark. Because these royalties are attributable to USBulb's and USLawn's businesses, they are considered to be derived in connection or complementary with the trade or business of NLBulb for purposes of subparagraph 2(a).

NLBulb made a loan to USHolding. USHolding used these funds to finance the initial establishment of its U.S. subsidiaries. For purposes of determining the portion of its annual interest payments that is derived in connection with the business of USBulb and USLawn, NLBulb allocates the interest expense between the businesses of USBulb and USLawn on the one hand and USHerring on the other in proportion to the book values of the assets held by the three subsidiaries of USHolding.

USHolding pays annual dividends to NLBulb. These dividends are less than the combined earnings and profits of USBulb and USLawn. For purposes of paragraph 2, the dividends are considered to be distributed out of the earnings and profits of USBulb and USLawn.

Finally, subparagraph 2(a)(ii) provides that a corporation resident in one of the States also will be entitled to the benefits of the Convention with respect to income derived from the other State if the income is "incidental" to the trade or business conducted in the recipient's State of residence. Subparagraph 2(d) provides that income derived from a State will be incidental to a trade or business conducted in the other State if the income is not described in subparagraph 2(b) (i.e., it is not derived in connection with a trade or business conducted in the other State) and the production of such income facilitates the conduct of the trade or business in the other State. An example of incidental income is the temporary investment of working capital derived from a trade or business. Finally, subparagraph 2(d) provides that in the case of a person electing to apply the EC attribution rule under subparagraph 2(h), the income considered to be incidental to a trade or business shall not be greater than four times the amount

of income that would have been considered to be incidental to the trade or business actually conducted in the Netherlands. In general, the Netherlands company will be allowed to derive incidental income attributable to amounts in excess of that produced by its own incidental investments to the extent of any uninvested working capital in the other EC companies whose activities are attributed to the Netherlands, up to a maximum of three times the Netherlands company's own incidental income. The following example illustrates the application of subparagraphs 2(a)(ii) and (d).

Example. NLCo is a corporation resident in the Netherlands. NLCo is engaged in the manufacture of machine tools in the Netherlands. UKCo is a sister corporation of NLCo that is a resident of the United Kingdom. USCo is a wholly-owned subsidiary of NLCo that is resident in the United States. USCo is engaged in the manufacture and sale of machine tools in the United States. UKCo manufactures machine tools in the United Kingdom. $10 of income derived from NLCo's business that is retained as working capital is invested in U.S. Government securities and other U.S. debt instruments until needed for use in NLCo's business. For purposes of satisfying the substantiality test under subparagraph 2(a)(i) with respect to dividend income received from USCo, NLCo elects to attribute to the Netherlands the business of UKCo. UKCo has $20 in uninvested working capital. The amount of U.S. debt instruments that may be considered to generate income incidental to NLCo's business is increased to $30. The maximum amount that may be invested is four times NLCo's own working capital, but not in excess of the uninvested working capital in the EC businesses whose activities are attributed to NLCo under subparagraph 2(h). Since UKCo has only $20 in uninvested working capital, the amount of NLCo's incidental investment is limited to this additional amount rather than the additional $30 otherwise permitted.

Substantiality

As indicated above, subparagraph 2(a)(i) provides that income that a resident of a State derives from the other State will be entitled to the benefits of the Convention under paragraph 2 only if the income is derived in connection with a trade or business conducted in the recipient's State of residence and that trade or business is "substantial" in relation to the income-producing activity in the other State (unless the income is incidental to the recipient's trade or business). Subparagraph 2(c) provides that whether the trade or business of the income recipient is substantial generally will be determined by reference to the relative sizes of the activities conducted in the two States and the relative contributions made to the conduct of the trade or businesses in the two States.

Substantiality Safe Harbor - Subparagraph 2(c)

In addition to this subjective rule, subparagraph 2(c) provides a safe harbor under which the trade or business of the income recipient will be deemed to be substantial based on three ratios that compare the size of the recipient's activities to those conducted in the other State. The three ratios compare: (i) the value of the assets in the recipient's State to the assets used in the other State; (ii) the gross income derived in the recipient's State to the gross income derived in the other State; and (iii) the payroll expense in the recipient's State to the payroll expense in the other State. The average of the three ratios with respect to the preceding taxable year must exceed 10 percent, and each individual ratio must exceed 7.5 percent. If any individual ratio does not exceed 7.5 percent for the preceding taxable year, the average for the three preceding taxable years may be used instead. (Thus, if the taxable year is 1998, the preceding year is 1997. If one of the ratios for 1997 is not greater than 7.5 percent, the average ratio for 1995, 1996, and 1997 with respect to that item may be used.) Finally, if a Netherlands person elects to attribute activities conducted in the EC to the Netherlands under subparagraph 2(h), the average of the three ratios for the preceding taxable year must exceed 60 percent, and each individual ratio must exceed 50 percent (and if any ratio does not exceed 50 percent for the preceding taxable year, the average for the preceding three taxable years may be used instead). In each case, only those items are included that are connected to the trade or business: assets, income and expenses unrelated to the trade or business are excluded from the calculation of the ratios.

The term "gross income" is not defined in the Convention. Thus, in accordance with paragraph 2 of Article 3 (General Definitions), in determining whether a person deriving income from United States sources is entitled to the benefits of the Convention, the United States will ascribe the meaning to the term that it has in the United States. In such cases, "gross income" will be defined as gross receipts less cost of goods sold.

The term "value" also is not defined in the Convention. Therefore, this term also will be defined under U.S. law for purposes of determining whether a person deriving income from United States sources is entitled to the benefits of the Convention. In such cases, "value" generally will be defined using the method used by the taxpayer in keeping its books for purposes of financial reporting in its country of residence. See, Treas. Reg. §1.884-5(e)(3)(ii)(A).

Unless the election under subparagraph 2(h) is made, only items actually located or incurred in the Netherlands are included in the computation of the ratios. If the person from whom the income in the other State is derived is not wholly controlled by the recipient (or by persons related to the recipient by operation

of the attribution rules under subparagraph 2(e)), then the items included in the computation with respect to such person must be reduced by a percentage equal to the percentage control held by persons not related to the recipient within the meaning of subparagraph 2(e). For instance, as described in Example 2 of paragraph XII. of the Memorandum of Understanding, if a Netherlands corporation derives income from a U.S. corporation in which it holds 80 percent of the shares, and unrelated parties hold the remaining shares, for purposes of subparagraph 2(c) only 80 percent of the assets, payroll and gross income of the U.S. company would be taken into account.

Consequently, if neither the recipient nor a person related to the recipient within the meaning of subparagraph 2(e) has an ownership interest in the person from whom the income is derived, the substantiality test always will be satisfied (the denominator in the computation of each ratio will be zero and the numerator will be a positive number). Paragraph II. of the Agreed Minutes to the Protocol confirms this result.

Paragraphs XII. and XV. of the Memorandum of Understanding set forth three examples illustrating the application of subparagraph 2(c).

Attribution Rules - Subparagraph 2(e)

Subparagraph 2(e) sets forth attribution rules under which activities conducted by certain parties related to the income recipient will be attributed to the income recipient for purposes of paragraph 2. A person that is a resident of one of the States will be considered to be engaged in the active conduct of a trade or business in that State if it meets one of seven conditions. A person to which an active trade or business is attributed under subparagraphs 2(e)(ii) through (vii) will be considered to carry on that business in addition to any active business in which such person may be engaged.

First, subparagraph 2(e)(i) clarifies that a person will be considered to be engaged in a trade or business in its State of residence if it directly conducts such trade or business.

Second, subparagraph 2(e)(ii) provides that a person will be considered to be engaged in a trade or business in its State of residence if such a trade or business is conducted by a partnership in which the person is a partner.

Third, subparagraph 2(e)(iii) provides that a person will be considered to be engaged in a trade or business in its State of residence if another person that is engaged in such a trade or business holds a "controlling beneficial interest" in the first person. The term "controlling beneficial interest" is defined in subparagraph 2(f) and is discussed below.

Fourth, subparagraph 2(e)(iv) provides that a person will be considered to be engaged in a trade or business in its State of residence if a controlling beneficial interest in the person is held by a group of five or fewer persons and each member of the group is engaged in activity in the person's State of residence that is a component part or is directly related to a trade or business conducted in that State.

Fifth, subparagraph 2(e)(v) provides that a person will be considered to be engaged in a trade or business in its State of residence if the person is a company that is member of a group of companies that form or could form (without regard to the residence of the companies) a consolidated group for tax purposes according to the law of that State, and the group is engaged in the active conduct of a trade or business in that State. It is not necessary that each member of the consolidated group be engaged in a trade or business for this purpose.

Sixth, subparagraph 2(e)(vi) provides that a person will be considered to be engaged in a trade or business in its State of residence if it owns, either alone or as a member of a group of five or fewer persons that are qualified persons, residents of member states of the European Communities, or residents of an identified state, a controlling beneficial interest in a person that is engaged in the active conduct of a trade or business in the State in which the first person is resident. The term "identified state" is described below.

Seventh, subparagraph 2(e)(vii) provides that a person will be considered to be engaged in the conduct of a trade or business in its State of residence if it is, together with another person that is so engaged, under the common control of a person (or a group of five or fewer persons) that is a qualified person, a resident of a member state of the European Communities or a resident of an identified state. If the person is under the control of a group, each member of the group must be a qualified person, resident of a member state of the European Communities or a resident of an identified state. The terms "common control" and "identified state" are described below.

For purposes of subparagraphs 2(e)(vi) and (vii), an identified state includes any country identified by agreement of the competent authorities, and that has effective provisions for the exchange of information with the State of which the person being tested is a resident. Lists of identified states as of the date of signature of the Convention with respect to the United States and the Netherlands are set forth in paragraph XVI. of the Memorandum of Understanding. In addition, paragraph IV. of the Agreed Minutes to the Protocol provides that with respect to the Netherlands, Portugal and Japan shall be considered to be identified states.

Subparagraph 2(f) defines "controlling beneficial interest" as a direct or indirect beneficial ownership interest that represents more than 50 percent of the value and voting power in a person. Although indirect ownership generally is taken into account for purposes of determining a controlling beneficial interest, subparagraph 2(f)(i) provides that an interest consisting of 50 percent or less of the value and voting power of any third person shall not be considered in determining the percentage of ownership held in a corporation. In addition, subparagraph 2(f)(ii) provides that no person shall be considered to be a part of a group owning a controlling beneficial interest in an entity unless such person holds directly a beneficial interest that represents at least 10 percent of the value and voting power of the entity. The following examples illustrate the application of this subparagraph.

Example 1. NLCo is a corporation resident in the Netherlands. NLCo is engaged in the active conduct of a trade or business in the Netherlands. NLCo owns 40 percent of the shares of XCo, a corporation. XCo owns 80 percent of the shares of NLSub, a corporation resident in the Netherlands. NLCo owns the remaining 20 percent of the shares of NLSub. NLSub derives income from the United States. Although NLCo directly holds 20 percent of the shares of NLSub and indirectly holds 32 percent of the shares of NLSub (i.e., the product of its 40 percent interest in XCo and XCo's 80 percent interest in NLSub), NLCo is not considered to own a controlling beneficial interest in NLSub. Under subparagraph 2(f)(i), NLCo's 40 percent interest in XCo may not be considered for purposes of determining the percentage of indirect ownership that NLCo holds in NLSub. Therefore, NLCo's active trade or business is not attributed to NLSub under subparagraph 2(e)(iii).

Example 2. USSub is a corporation resident in the United States. USSub is engaged in the active conduct of a trade or business in the United States. 30 percent of the shares of USSub are held by UKCo, a corporation resident in the United Kingdom, 20 percent are held by USParent, a corporation resident in the United States, 5 percent are held by FCo, a corporation resident in France, and the remaining shares of USSub are held by individuals resident in Hong Kong. Although FCo, UKCo and USParent collectively own 55 percent of the shares of USSub, this group of corporations is not considered to own a controlling beneficial interest in USSub. Subparagraph 2(f)(ii) provides that no person shall be considered to be part of a group owning a controlling beneficial interest in an entity unless such person holds directly at least 10 percent of the value and voting power of such entity. Since Fco owns only 5 percent of the shares of USSub, its interest is not considered for purposes of determining whether there is a group that owns a controlling beneficial interest in USSub. The only persons with the requisite level of ownership in USSub are USParent (20 percent) and UKCo (30 percent). Since these two corporations collectively do not own more than 50 percent of the

value and voting power of USSub, USParent is not considered to be a part of a group that owns a controlling beneficial interest in USSub. Therefore, USSub's active trade or business is not attributed to USParent under subparagraph 2(e)(vi).

Subparagraph 2(g) provides that for purposes of subparagraph 2(e) a person or group shall be deemed to have "common control" of two persons if it holds a controlling beneficial interest in each such person.

Paragraphs XII. and XV. of the Memorandum of Understanding set forth three examples illustrating the application of subparagraph 2(e) and related provisions of paragraph 2. The following examples further illustrate the application of subparagraph 2(e).

Example 1. NLCo is a corporation resident in the Netherlands. NLCo is not engaged in the active conduct of a trade or business in the Netherlands. All the shares of NLCo are owned by NLParent, a corporation resident in the Netherlands that is engaged in an active trade or business there. Subparagraph 2(e)(iii) provides that a resident of one of the States will be considered to conduct a trade or business in that State if a person that is so engaged holds a controlling beneficial interest in the first person. Since NLParent is engaged in the conduct of a trade or business in the Netherlands and it owns a controlling beneficial interest in NLCo, NLCo is considered to conduct the trade or business conducted by NLParent.

Example 2. NLJV is a corporation resident in the Netherlands. The shares of NLJV are owned equally by NLSC, NLConv and NLTech, all of which are corporations resident in the Netherlands. NLSC operates a factory in the Netherlands that manufactures superchargers for automobile engines. NLConv operates a factory in the Netherlands that manufactures convertible tops for automobiles. NLTech is the licensee of automotive manufacturing technology from a related party engaged in the manufacture of automobiles in a third state. NLJV was formed by its three owners as a joint venture to design and manufacture for distribution in the United States a new automobile with a supercharged engine and a convertible top. All the design and manufacturing activities related to the new automobile are conducted by NLSC, NLConv and NLTech's shareholder. NLTech's sole function is to sublicense manufacturing technology to the venture. NLJV is not directly engaged in the conduct of a trade or business in the Netherlands, and the activities of NLTech do not constitute an active trade or business. However, the activities of NLTech are a component part of the overall business of designing and manufacturing a new automobile. Taken together, the activities of NLTech, NLConv and NLSC constitute an active trade or business. Under subparagraph 2(e)(iv), these activities are considered to be conducted by NLJV.

Example 3. USParent is a corporation resident in the United States. USParent owns all the shares of UKCo, a corporation resident in the United Kingdom. UKCo owns all the shares of USSub, a corporation resident in the United States. USSub is not engaged in the conduct of a trade or business. USParent is engaged in the active conduct of a trade or business in the United States.

For purposes of subparagraph 2, USSub will be considered to conduct the trade or business conducted by USParent. Subparagraph 2(e)(v) provides that a company that is a resident of one of the States will be considered to conduct a trade or business in that State that is conducted by another member of a group of corporations that form or could form a consolidated group for tax purposes under the law of that State. In determining whether the law of that State would permit a group to from a consolidated group for tax purposes, such law is to be applied without regard to the residence of any of the members of the group. Thus, despite the fact that UKCo is not a U.S. corporation, subparagraph 2(e)(v) will attribute the trade or business of USParent to USSub because if UKCo were a U.S. corporation, USParent, UKCo and USSub could form a consolidated group for U.S. tax purposes.

Example 4. USCo is a corporation resident in the United States. USCo is not engaged in the conduct of a trade or business. USTB is a corporation resident in the United States. USTB is engaged in the active conduct of a trade or business in the United States. 20 percent of the shares of USTB and of USCo are owned by FCo, a corporation resident in France that is a resident of a member state of the European Communities within the meaning of subparagraph 8(i). 20 percent of the shares of USTB and USCo are owned by NLHolding, a corporation resident in the Netherlands. 20 percent of the shares of USTB and USCo are owned by EgyptCo, a corporation resident in Egypt. The remaining shares of USTB and USCo are held by individuals resident in Hong Kong.

Pursuant to subparagraph 2(e)(vii), USCo is considered to conduct the trade or business conducted by USTB in the United States. That subparagraph provides that a trade or business will be attributed from one person to another if both persons are under the common control of a person or group if each such person is a qualified person, a resident of a member state of the European Communities, or a resident of an identified state. Since FCo, NLHolding and EgyptCo collectively own 60 percent of the shares of both USTB and USCo, USTB and USCo are under the common control of these three companies within the meaning of subparagraph 2(g). FCo's ownership is counted for this purpose because FCo is a resident of a member state of the European Communities. NLHolding's ownership is counted because it is a qualified resident. EgyptCo's ownership is counted because Egypt is included in the list of identified states that have effective provisions for the exchange of information with the United States in paragraph XVI. of the Memorandum of Understanding.

EC Attribution - Subparagraph 2(h)

Subparagraph 2(h) provides rules under which, for purposes of the substantiality test under subparagraph 2(c), certain activities conducted by persons in member states of the European Communities may be attributed to related persons engaged in the conduct of an active trade or business in the Netherlands. Subparagraph 2(h) provides that if a person is a resident of the Netherlands and is considered to be engaged in the active conduct of a trade or business in the Netherlands under the principles of subparagraph 2(e), and activity that is a component part of, or directly related to the trade or business conducted in the Netherlands is conducted in other member states of the European Communities, the person may elect to treat its proportionate share of such activity as if it were conducted in the Netherlands, consistent with the rules of subparagraph 2(e). This attribution only will be made, however, if each of the following three ratios exceeds 15 percent:

(i) The ratio of the value of the assets actually used or held for use in the active conduct of the trade or business in the Netherlands to the proportionate share of such assets used or held for use within all such member states;

(ii) The ratio of gross income actually derived from the active conduct of the trade or business in the Netherlands to the proportionate share of the gross income so derived within all such member states; and

(iii) The ratio of payroll expenses of the trade or business for services actually performed in the Netherlands to the proportionate share of the payroll expenses of the trade or business for services performed within all such member states.

The computation of these ratios follows the rules set forth with respect to the computation of the ratios under subparagraph 2(c). In addition, activities only will be attributed from a resident of an EC state to the Netherlands person if the two persons bear a relationship described in subparagraph 2(e). The following example illustrates the application of subparagraph 2(h) and its interaction with subparagraphs 2(c) and 2(e).

Example. USCo is a corporation resident in the United States. USCo is engaged in the active conduct of a trade or business in the United States. NLHolding is a corporation resident in the Netherlands. NLHolding owns 50 percent of the shares of USCo. NLHolding is not engaged in a trade or business. NLHolding owns 80 percent of the shares of NLCo, a corporation resident in the Netherlands. NLCo is engaged in the active conduct of a trade or business in the Netherlands. NLHolding also owns 100 percent of the shares of UKCo, a corporation resident in the United Kingdom. UKCo is engaged in the active conduct of a trade or business in the

United Kingdom. UKCo, NLCo and USCo are engaged in the same trade or business. NLHolding receives dividend and royalty income from USCo in the 1998 taxable year. Set forth below are the asset values, gross income and payroll expenses of USCo, NLCo and UKCo for the 1997 taxable year that are related to this trade or business.

	Assets	Gross Income	Payroll
USCo	$520	$100	$50
NLCo	23.75	7.5	5
UKCo	125	25	15

These items are the same for the 1994, 1995, and 1996 taxable years. Under subparagraph 2(e)(vi), the trade or business conducted by NLCo is considered to be conducted by NLHolding. However, for purposes of subparagraph 2(c), the assets, gross income and payroll attributed from NLCo to NLHolding must be reduced by the percentage of shares that are not owned by NLHolding (20%). Similarly, the assets, gross income and payroll taken into account for purposes of subparagraph 2(c) must be reduced by the percentage of shares of USCo that are not owned by NLHolding (50%). Therefore the amounts of these items for NLCo and USCo are recomputed for purposes of subparagraph 2(c) as follows:

	Assets	Gross Income	Payroll
USCo	$260	$50	$25
NLCo	19	6	4

In order for the trade or business that NLHolding is considered to conduct in the Netherlands to be considered substantial in relation to the trade or business conducted by USCo, the average of the ratios of their relative assets, gross income and payroll must be greater than 10 percent and each ratio must be greater than 7.5 percent. The three ratios are 7.3%, 12% and 16%, respectively. Although the average of these three ratios is greater than 10 percent (11.8%), the Netherlands trade or business is not considered to be substantial because the assets ratio is not greater than 7.5 percent.

However, applying the principles of subparagraph 2(e)(vi), the activities of UKCo that are related to the trade or business conducted in the United States may be considered to be conducted by NLHolding under subparagraph 2(h), as long as the ratios of the Netherlands assets, gross income and payroll to the UK assets, gross income and payroll exceed 15 percent. Since NLHolding owns all the shares of UKCo, the full amounts of the assets, gross income and payroll of UKCo are compared to the corresponding amounts for NLHolding. These ratios are 15.2%, 24%, and 26.7%, respectively. Since all the ratios are above 15 percent, they may be attributed to NLHolding for purposes of subparagraph 2(c). Therefore, the NLHolding amounts are added to the UKCo amounts and compared to the USCo amounts. These values are as follows:

	Assets	Gross Income	Payroll
USCo	$260	$50	$25
NLHolding + UKCo	144	31	19

Since NLHolding has elected to apply the EC attribution rule of subparagraph 2(h), each ratio must be greater than 50 percent and the average of the three ratios must be greater than 60 percent. The ratios of the assets, gross income and payroll are 55.4%, 62% and 76 percent, respectively. The average of the three ratios is 64.5%. Since all the ratios are greater than 50 percent and the average of the three ratios is greater than 60 percent, the Netherlands trade or business, after attribution from the EC, is considered to be substantial under subparagraph 2(c).

Headquarter Companies - Paragraph 3

Paragraph 3 provides that a resident of one of the States shall be entitled to all the benefits of the Convention if that person functions as a headquarter company for a multinational corporate group. All corporations that the headquarter company supervises are included in the group. The headquarter company does not have to own shares in the companies that it supervises. In order to be considered a headquarter company, the person must meet several requirements that are enumerated in paragraph 3. These requirements are discussed below.

Overall Supervision and Administration - Subparagraph 3(a)

Subparagraph 3(a) provides that the person must provide a substantial portion of the overall supervision and administration of the group. This activity may include group financing, but group financing may not be the principal activity of the person functioning as the headquarter company. Paragraph V. of the Agreed Minutes to the Protocol clarifies that it is understood that the activities described in this subparagraph must be performed in the State of residence of the headquarter company.

Paragraph XVIII. of the Memorandum of Understanding sets forth several understandings of the negotiators regarding this subparagraph. First, it provides that a person only will be considered to engage in supervision and administration if it engages in a number of the following activities: group financing, pricing, marketing, internal auditing, internal communications, and management. Other activities also could be part of the function of supervision and administration.

In determining whether group financing constitutes the person's principal activity, paragraph XVIII. provides that a simple comparison of gross income from the company's various activities cannot be used alone. Other indicia also would be relevant. For instance, the payroll expense attributable to each

of the headquarter functions could also be a useful indicator of whether group financing constitutes a company's principal activity.

Paragraph XVIII. also provides that in determining whether a "substantial portion" of the overall supervision and administration of the group is provided by the headquarter company, its headquarter-related activities must be substantial in relation to the same activities for the same group performed by other entities. An example is provided under which it is determined that a Netherlands headquarter company provides a substantial portion of the overall supervision and administration for a group of North American and European companies despite the fact that the Netherlands company's Japanese parent also participates in this activity. The determination turns principally on the fact that the Netherlands company is responsible for implementation of overall policies that the Japanese company sets for the worldwide group, which includes companies not under the purview of the Netherlands company, and that the capital and payroll devoted to these activities by the Netherlands company is large in comparison to the capital and payroll devoted to these activities by the Japanese company.

Subparagraph 3(a) does not require that the group that is supervised include persons in the other State. However, it is anticipated that in most cases the group will include such persons, due to the requirement discussed below that the income derived by the headquarter company be derived in connection with or be incidental to an active trade or business supervised by the headquarter company.

Active Trade or Business - Subparagraph 3(b)

Subparagraph 3(b) provides that the corporate group supervised by the headquarter company must consist of corporations resident in, and engaged in active trade or businesses in, at least five countries. Furthermore, each of these businesses must generate at least 10 percent of the gross income of this group for the taxable year in question. For purposes of the 10 percent gross income requirement, the income from multiple countries may be aggregated, as long as there are at least five individual countries or groupings that satisfy the 10 percent requirement. If the gross income requirement under this subparagraph is not met for a taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year. The following examples illustrate the application of this subparagraph.

Example 1. NLHQ is a corporation resident in the Netherlands. NLHQ functions as a headquarter company for a group of companies. These companies are resident in the United States, Canada, Mexico, Brazil, Argentina, Chile, Bolivia, Colombia, Venezuela, New Zealand and Australia. The gross income generated by each of these companies for 1996 and 1997 are as follows:

	1996	1997
United States	$40	$45
Canada	25	18
Mexico	10	20
Brazil	20	25
Argentina	10	12
Chile	5	6
Bolivia	2	2
Colombia	5	8
Venezuela	10	12
Australia	30	30
New Zealand	5	5
Total	$162	$183

For 1996, 10 percent of the gross income of this group is equal to $16.20. Only the United States, Canada, Brazil and Australia satisfy this requirement for that year. The other companies in the group may be aggregated to meet this requirement. Since they have a total gross income of $47, they are treated as the fifth member of the group for purposes of subparagraph 3(b).

In the following year, 10 percent of the gross income is $18.30. Only the United States, Mexico, Brazil, and Australia satisfy this requirement. The other companies in the group again may be aggregated to meet the requirement that there be five members with the requisite level of income. Since they have a total gross income of $63, they are treated as the fifth member of the group for purposes of subparagraph 3(b). The fact that Canada has replaced Mexico in the grouping is immaterial. The composition of the grouping may change from year to year.

Example 2. USHQ is a corporation resident in the United States. USHQ functions as a headquarter company for a group of companies. These companies are resident in the Netherlands, Belgium, Germany, Sweden, and France. The companies in the Netherlands, Germany, Belgium and France are active exclusively in their states of residence. The Swedish company conducts activities through permanent establishments in Norway, Denmark and Finland, in addition to conducting activities in Sweden. The gross income of each company and the location of the activities generating the that income for the 1997 taxable year are set forth below.

Company	Situs	Amount
France	France	$50
Germany	Germany	75
Netherlands	Netherlands	20
Belgium	Belgium	20
Sweden	Sweden	10
Sweden	Finland	5
Sweden	Denmark	5
Sweden	Norway	5
		$190

Subparagraph 3(b) requires that there be five companies or groupings of companies, each of which accounts for at least 10 percent of the overall group's gross income. The total gross income of Sweden, France, Germany, the Netherlands and Belgium are greater than 10 percent of the total gross income of the group, and the group satisfies subparagraph 3(b).

Single Country Limitation - Subparagraph 3(c)

Subparagraph 3(c) provides that the business activities carried on in any one country other than the headquarter company's state of residence must generate less than 50 percent of the gross income of the group. If the gross income requirement under this subparagraph is not met for a taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year. The following example illustrates the application of this subparagraph.

Example. NLHQ is a corporation resident in the Netherlands. NLHQ functions as a headquarter company for a group of companies. NLHQ derives dividend income from a United States subsidiary in the 1998 taxable year. The state of residence of each of these companies, the situs of their activities and the amounts of gross income attributable to each for the years 1995 through 1998 are set forth below.

Company	Situs	1998	1997	1996	1995	1994
United States	U.S.	$100	$100	$95	$90	$85
United States	Mexico	10	8	5	0	0
United States	Canada	20	18	16	15	12
Germany	Germany	40	42	38	36	35
France	France	35	32	30	30	28
Netherlands	NL	25	25	24	22	20
United Kingdom	U.K.	30	32	30	28	27
		$260	$257	$238	$221	$207

Since the United States' total gross income of $130 in 1998 is not less than 50 percent of the gross income of the group, subparagraph 3(c) is not satisfied with respect to the dividends derived in 1998. However, the United States' average gross income for the preceding four years may be used in lieu of the preceding year's average. The United States' average gross income for the years 1994-1997 is $111.00 ($444/4). The group's total average gross income for these years is $230.75 ($923/4). Since $111.00 represents 48.1 percent of the group's average gross income for the years 1994 through 1997, the United States satisfies the requirement under subparagraph 3(c).

Other State Gross Income Limitation - Subparagraph 3(d)

Subparagraph 3(d) provides that no more than 25 percent of the headquarter company's gross income may be derived from the

other State. Thus, if the headquarter company's gross income for the taxable year is $200, no more than $50 of this amount may be derived from the other State. If the gross income requirement under this subparagraph is not met for a taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year.

Independent Discretionary Authority - Subparagraph 3(e)

Subparagraph 3(e) requires that the headquarter company have and exercise independent discretionary authority to carry out the functions referred to in subparagraph 3(a). Thus, if the headquarter company was nominally responsible for group financing, pricing, marketing, and other management functions, but merely implemented instructions received from another entity, the headquarter company would not be considered to have and exercise independent discretionary authority with respect to these functions. This determination is made individually for each function. For instance, a headquarter company could be nominally responsible for group financing, pricing, marketing and internal auditing functions, but another entity could be actually directing the headquarter company as to the group financing function. In such a case the headquarter company would not be deemed to have independent discretionary authority for group financing, but it might have such authority for the other functions. Functions for which the headquarter company does not have and exercise independent discretionary authority are considered to be conducted by an entity other than the headquarter company for purposes of subparagraph 3(a).

Income Taxation Rules - Subparagraph 3(f)

Subparagraph 3(f) requires that the headquarter company be subject to the same income taxation rules in its country of residence as persons described in paragraph 2. The reference to paragraph 2 means that the headquarter company must be subject to the income taxation rules to which a company engaged in the active conduct of a trade or business would be subject. Thus, if one of the States introduced special taxation legislation that would impose a lower rate of income tax on headquarter companies than was imposed on companies engaged in the active conduct of a trade or business, or would provide for an artificially low taxable base for such companies, a headquarter company subject to these rules would not be entitled to the benefits of the Convention under paragraph 3.

In Connection With or Incidental to Trade or Business - Subparagraph 3(g)

Finally, subparagraph 3(g) requires that the income derived in the other State be derived in connection with or be incidental to the active business activities referred to in subparagraph 3(b).

This determination is made under the principles set forth in paragraph 2. For instance, if a Netherlands company acted as a headquarter company for a group that included a United States corporation, the group was engaged in the design and manufacture of computer software, but the U.S. company was also engaged in the design and manufacture of photocopying machines, the income that the Netherlands company derived from the United States would have to be derived in connection with or be incidental to the income generated by the computer business in order to be entitled to the benefits of the Convention under paragraph 3. Similarly, interest income received from the U.S. company also would be entitled to the benefits of the Convention under this paragraph as long as the interest was attributable to a trade or business supervised by the headquarter company. Interest income derived from an unrelated party would normally not, however, satisfy the requirement of this subparagraph.

Derivative Benefits - Paragraph 4

Paragraph 4 sets forth a limited derivative benefits test. In general, a derivative benefits test entitles the resident of a state to treaty benefits if the beneficial owner of the resident would have been entitled to the same benefit had the income in question flowed directly to that owner. Paragraph 4 provides a derivative benefits test under which a Netherlands company may be entitled to the benefits of the Convention with respect to Articles 10 (Dividends), 11 (Branch Tax), 12 (Interest) and 13 (Royalties). A Netherlands company may not obtain other benefits of the Convention under paragraph 4. In order to be entitled to the enumerated benefits of the Convention under this paragraph, the Netherlands company must meet an ownership test and a base reduction test. The ownership test is described below. The base reduction test is described in the discussion of paragraph 5.

30/70 Netherlands/EC Ownership - Subparagraph 4(a)

Subparagraphs 4(a)(i) and (ii) set forth a 30/70 Netherlands/EC ownership test that is similar, but not identical to that set forth under subparagraph 1(c)(iii).

First, subparagraph 4(a)(i) provides that more than 30 percent of the vote and value of all the company's shares must be owned directly or indirectly by qualified persons resident in the Netherlands. Unlike the test under paragraph 1, there is no limit on the number of shareholders. In addition, more than 30 percent of any disproportionate class of shares (as defined in subparagraph 8(c)) also must be owned directly or indirectly by qualified persons resident in the Netherlands. As under subparagraph 1(d), share ownership is to be determined under the principles of Code section 883(c)(4). The restrictions imposed on indirect ownership by subparagraph 8(k) with respect to certain tests under paragraph 1 do not apply under this subparagraph.

Second, subparagraph 4(a)(ii) provides that more than 70 percent of all the shares (i.e., 70 percent of any disproportionate shares and 70 percent of the aggregate vote and value of all of the company's shares) must be owned directly or indirectly by any number of qualified persons or persons that are residents of member states of the European Communities (as defined in subparagraph 8(i)). As under subparagraph 4(a)(i), share ownership is to be determined under the principles of Code section 883(c)(4) and the restrictions imposed on indirect ownership by subparagraph 8(k) with respect to certain tests under paragraph 1 do not apply under this subparagraph.

For purposes of subparagraph 4(a)(ii), subparagraph 4(b) provides that shares will be considered to be held by residents of the European Communities only if the shareholders are residents of member states of the European Communities that have a comprehensive income tax convention with the United States, and the particular payment in respect of which treaty benefits are claimed would be subject to a rate of tax under such comprehensive income tax convention that is equal to or less than the rate imposed on such payment under the Convention. The following examples illustrate the application of this subparagraph.

Paragraph XI. of the Memorandum of Understanding sets forth the understanding of the negotiators that a Dutch investment company ("beleggingsinstelling") may satisfy the qualified person ownership requirement under this paragraph by relying on the so-called "global method" of determining ownership that is used for purposes of obtaining a refund for Netherlands shareholders with respect to foreign dividend and interest withholding taxes. This method is discussed above under subparagraph 1(d).

Example 1. NLCo is a corporation resident in the Netherlands. Sixty percent of the shares of NLCo are owned by UKCo, a corporation resident in the United Kingdom. The remaining 40 percent of the shares of NLCo are owned by NLParent, a corporation resident in the Netherlands that is entitled to the benefits of the Convention under subparagraph 1(c)(i). NLParent therefore is a qualified person resident in the Netherlands. All the shares of UKCo are owned by NZCo, a corporation resident in New Zealand. The shares of NZCo are publicly-traded on a stock exchange in New Zealand. NLCo derives portfolio dividends from the United States for the 1998 taxable year.

NLCo satisfies the ownership requirement of subparagraph 4(a)(i) because 40 percent of its shares are owned by NLParent. NLCo does not satisfy the ownership requirements of subparagraph 4(a)(ii) despite the fact that the other 60 percent of its shares are owned by UKCo. The application of paragraph 4 turns on the identity of the ultimate, indirect owners of the company seeking the benefits of the Convention. In this case the ultimate indirect owner of NLCo is NZCo. Although NZCo would satisfy the derivative

benefit test under subparagraph 4(b) because the income tax convention between the United States and New Zealand would impose the same rate of taxation on portfolio dividends that is imposed under the Convention (15 percent), NZCo is not a qualified person nor a resident of a member state of the European Communities. Consequently the requirement of subparagraph 4(a)(ii) is not satisfied.

Example 2. The facts are the same as in Example 1, except that 60 percent of the shares of NLCo are owned directly by NZCo and the shares of NZCo are owned by UKCo. The principal class of the shares of UKCo is listed on the London Stock Exchange and substantially and regularly traded. UKCo is entitled to all the benefits of the income tax convention between the United States and the United Kingdom. UKCo would be entitled to the benefits of the Convention under subparagraph 1(c)(i), applied as if the United Kingdom were the Netherlands. UKCo therefore is a resident of a member state of the European Communities as defined in subparagraph 8(i). NLCo satisfies the base reduction test under paragraph 5.

The 30 percent Netherlands ownership requirement under subparagraph 4(a)(i) is satisfied because NLParent owns 40 percent of the shares of NLCo and NLParent is a qualified person resident in the Netherlands. Since the remaining shares of NLCo are indirectly owned by UKCo, a resident of a member state of the European Communities, the 70 percent EC ownership requirement under subparagraph 4(a)(ii) also is satisfied, because portfolio dividends are subject to the same rate of taxation under the income tax convention between the United State and the United Kingdom that is imposed under the Convention (15 percent). Since subparagraph 8(k) does not apply for purposes of paragraph 4, the fact that the intermediate owner of NLCo (NZCo) is not a resident of a member state of the European Communities is not relevant. Since it is assumed that the base reduction test under paragraph 5 is satisfied, NLCo is entitled under paragraph 4 to the benefits of the Convention with respect to the portfolio dividends.

Example 3. NLSub is a corporation resident in the Netherlands. NLSub has one class of shares. 32 percent of the shares of NLSub are owned by NLParent, a corporation resident in the Netherlands. The principal class of shares of NLParent is listed and traded as described in subparagraph 1(c)(i). NLParent therefore is a qualified person. 43 percent of the shares of NLSub are owned by UKParent, a corporation resident in the United Kingdom. 75 percent of the shares of UKParent are owned by ItaliaCo, a corporation resident in Italy. The principal class of shares of ItaliaCo is listed on the Milan Stock Exchange and substantially and regularly traded as defined in subparagraph 8(f). ItaliaCo is entitled to all the benefits of the income tax convention between the United States and Italy. The remaining 25 percent of the shares of UKParent are owned by NLHolding, a corporation resident in the Netherlands. The principal class of

shares of NLHolding is listed on the Amsterdam Stock Exchange and substantially and regularly traded as defined in subparagraph 8(f). The remaining 25 percent of the shares of NLSub are owned by X, an individual. NLSub satisfies the base reduction test under paragraph 5. In the 1998 taxable year, NLSub receives portfolio dividends from a corporation in the United States.

NLSub satisfies the 30 percent Dutch ownership requirement under subparagraph 4(a)(i) because 32 percent of its shares are owned directly by NLParent, a qualified person resident in the Netherlands, and under the principles of Code section 883(c)(4) 11 percent of its shares are owned indirectly by NLHolding, also a qualified person resident in the Netherlands. NLSub also satisfies the 70 percent EC ownership requirement under subparagraph 4(a)(ii) because, in addition to the 43 percent of its shares that are owned directly or indirectly by qualified persons resident in the Netherlands, 32 percent of its shares are owned indirectly by ItaliaCo, a resident of a member state of the European Communities. The ownership attributable to ItaliaCo is considered for purposes of subparagraph 4(a)(ii) because the rate of tax that the United States may impose on portfolio dividends paid by a United States corporation under the United States-Italy income tax convention is the same as the rate that may be imposed under the Convention with respect to such payments (15 percent). Therefore 75 percent of the shares of NLSub are considered to be owned directly or indirectly by qualified persons and residents of member states of the European Communities. Since it is assumed that the base reduction test of paragraph 5 is satisfied, NLSub is entitled to the benefits of the Convention with respect to the dividend income received from the United States.

Example 4. NLCo is a corporation resident in the Netherlands. 60 percent of the shares of NLCo are owned by ItaliaCo, a corporation resident in Italy. 40 percent of the shares of NLCo are owned by an individual resident in the Netherlands. All the shares of ItaliaCo are owned by an individual resident in Italy. NLCo derives interest income from the United States.

NLCo satisfies the 30 percent Netherlands ownership requirement under subparagraph 4(a)(i) because the individual shareholder with 40 percent of the shares of NLCo is a qualified person with more than 30 percent of the shares of NLCo.

Although the indirect owner of the remaining shares of NLCo is a resident of a member state of the European Communities, NLCo does not satisfy the 70 percent EC ownership test under subparagraph 4(a)(ii). The indirect owner of the shares is an individual resident of Italy. The rate of tax imposed on interest income under the income tax convention between the United States and Italy (15 percent) is higher than the rate imposed on such income under the Convention (zero). Therefore under subparagraph 4(b) ItaliaCo is not treated as a resident of a member state of the

European Communities for purposes of paragraph 4, and NLCo is not entitled to the benefits of the Convention with respect to the interest income.

Base Reduction - Paragraph 5

Paragraph sets forth two base reduction tests that are applied in determining whether a person is entitled to benefits under other provisions of Article 26. The general base reduction test under subparagraph 5(a) is applied under subparagraph 1(d) and paragraph 4. The conduit base reduction test under subparagraph 5(d) is applied to certain conduit companies under subparagraph 1(c)(iv).

General Base Reduction Test - Subparagraph 5(a)(i)

Subparagraph 5(a)(i) sets forth the general base reduction test that is applicable to residents of either State who seek entitlement to the benefits of the Convention under subparagraph 1(d) or paragraph 4. In order to be entitled to the benefits of the Convention under either of those tests a person must meet the requirements under those tests as well as the base reduction test under subparagraph 5(a).

The base reduction test under subparagraph 5(a) includes a test that is applicable to residents of either State and an alternative test that residents of the Netherlands may apply in lieu of the generally applicable test.

The generally applicable test is described under subparagraph 5(a)(i). It provides that a person will meet the base reduction test of paragraph 5 if less than 50 percent of the person's gross income is used, directly or indirectly, to make "deductible payments" in the current taxable year to persons that are not qualified persons. The term qualified persons is defined under subparagraph 8(g).

As discussed previously, gross income generally is equal to the current year's gross receipts less cost of goods sold. For purposes of paragraph 5, this definition is modified by subparagraph 5(b). For purposes of paragraph 5, gross income is the greater of gross income (determined under the general definition) for the preceding taxable year, or the average of the annual amounts of gross income for the four taxable year preceding the current taxable year. The following example illustrates the application of subparagraph 5(b).

<u>Example</u>. The taxable year is 1997. The taxpayer's gross income for the preceding four taxable years is as follows:

Year	Amount
1996	$100
1995	95
1994	110
1993	105

The taxpayer's gross income for the 1997 taxable year for purposes of paragraph 5 is the greater of the gross income for 1996 or the average gross income for the years 1993 through 1996. The average gross income for the years 1993 through 1996 is $102.50. Since this amount is greater than the $100 in gross income for 1996, the taxpayer's gross income for the 1997 taxable year for purposes of paragraph 5 is deemed to be $102.50.

The term "deductible payments" is defined in subparagraph 5(c). In general, deductible payments includes all payments that are deductible for tax purposes, such as payments for interest and royalties. The term does not, however, include payments at arm's length for the purchase, use of, or right to use tangible property in the ordinary course of business, or remuneration at arm's length for services performed in the country of residence of the person making the payment. These exceptions may be modified by mutual agreement of the competent authorities.

The base reduction test applies to indirect as well as direct payments to persons that are not qualified persons. Thus, if a person makes payments of items included in the definition of deductible payments to a qualified person, and the qualified person transfers all or a portion of this amount to persons that are not qualified persons, the portion of the payment that was transferred to the non-qualified persons would not be treated as a payment to a qualified person. In identifying indirect payments to non-qualified persons, it is not intended that a payment automatically be treated as an indirect payment to a non-qualified person solely because the qualified person made similar payments to a non-qualified person. It is only intended that a payment to a qualified person be treated as an indirect payment to a non-qualified person when the facts indicate that there is a relationship between the two payments such that the obligation on the part of the qualified person to make the payment to the non-qualified person would not have been incurred absent the obligation of the initial payor to make a payment to the qualified person, or that the non-qualified person in substance was the recipient of the payment under a conduit arrangement. The following example illustrates the application of this subparagraph.

Example. NLCo is a corporation resident in the Netherlands. For the 1997 taxable year, NLCo makes deductible payments to two persons: $10 is paid to a corporation resident in the Netherlands that is a qualified person and $60 is paid to a corporation resident in Hong Kong. NLCo's gross income for the four taxable years preceding 1997 is as follows:

Year	Amount
1996	$110
1995	110
1994	120
1993	125

For purposes of subparagraph 5(a)(i), the deductible payments to the qualified person are disregarded. Only the $60 paid to the Hong Kong corporation is considered. NLCo's gross income for the taxable year is considered to be $116.25 (the average for the taxable year 1993-96, which is greater than the amount for 1996). 50 percent of this amount is $58.13. Since the deductible payments to non-qualified persons for 1997 were $60, the base reduction test under subparagraph 5(a)(i) is not satisfied.

30/70 Base Reduction Test - Subparagraph 5(a)(ii)

Subparagraph 5(a)(ii) sets forth an additional base reduction test that is available to residents of the Netherlands. This subparagraph provides that the base reduction test will be satisfied if a two-part test is met. First, under clause (A) of the subparagraph, less than 70 percent of the person's gross income for the taxable year is used, directly or indirectly, to make deductible payments to persons that are not qualified persons. Second, under clause (B), less than 30 percent of the person's gross income for the taxable year is used, directly or indirectly, to make deductible payments to persons that are neither qualified persons nor residents of member states of the European Communities.

The definitions of gross income and deductible payments are the same as those discussed above with respect to the general base reduction test under subparagraph 5(a)(i). The term residents of member states of the European Communities is defined under subparagraph 8(i). The following examples illustrate the application of subparagraph 5(a)(ii).

Example 1. The facts are the same as those described in the example set forth under the discussion of subparagraph 5(a)(i), above. Thus, NLCo's gross income for the taxable year is considered to be $116.25, and NLCo made deductible payments of $10 to a qualified person and $60 to a non-qualified person. NLCo satisfies the test set forth under clause (A) of subparagraph 5(a)(ii) because its $60 in deductible payments to a non-qualified person is less than 70 percent of its gross income (70% of its gross income is $81.38, or the product of .70 and $116.25). NLCo does not, however, satisfy the test set forth under clause (B) of subparagraph 5(a)(ii) because more than 30 percent of its gross income was used to make deductible payments to a person (the Hong Kong corporation) that is neither a qualified person nor a resident of a member state of the European Communities.

Example 2. The facts are the same as in Example 1, except

that instead of making $60 in deductible payments to a Hong Kong corporation, NLCo pays $60 in deductible payments to an individual resident in Germany. The individual satisfies the definition of a resident of a member state of the European Communities set forth under subparagraph 8(i).

As in Example 1, NLCo satisfies the test set forth under clause (A) of subparagraph 5(a)(ii) because its $60 in deductible payments to a non-qualified person (the individual resident in Germany) is less than 70 percent of its gross income. Unlike Example 1, however, NLCo also satisfies the test set forth under clause (B) of subparagraph 5(a)(ii) because it made no deductible payments to persons that are neither qualified person nor residents of member states of the European Communities. NLCo satisfies the base reduction test under paragraph 5.

Conduit Base Reduction Test - Subparagraph 5(d)

Subparagraph 5(d) sets forth a special conduit base reduction test that applies solely for purposes of subparagraph 1(c)(iv). Under this test, a company that would qualify for the benefits of the Convention under subparagraph 1(c)(ii) or (c)(iii) but for the fact that it is a conduit company as defined under subparagraph 8(m) will be entitled to the benefits of the Convention if it satisfies the conduit base reduction test.

The conduit base reduction test is the same as the general base reduction test set forth under subparagraph 5(a), except that the definition of the term "deductible payments" under subparagraph 5(c) is modified for purposes of this test to include only those deductible payments that (i) are made to an associated enterprise (as described in Article 9 (Associated Enterprises) (determined without regard to the residence of the payor and the payee), and (ii) are subject to an aggregate rate of tax (including withholding taxes) in the hands of the recipient that is less than 50 percent of the rate that would have been applicable had the payment been received by a person subject to the normal taxing regime in the State of residence of the payor. In determining whether a person is entitled to the benefits of the Convention with respect to income derived from the United States, the aggregate rate of tax borne by an item of income will be determined under the principles set forth under Code section 954(b)(4). The following example illustrates the application of this subparagraph.

Example. NL-1 is a corporation resident in the Netherlands. All of the shares of NL-1 are owned by NL-2, a corporation resident in the Netherlands that is entitled to the benefits of the Convention under subparagraph 1(c)(i). NL-1's gross income (determined under the rules of subparagraph 5(b)) for the 1996 taxable year was $100. NL-1 receives $100 of interest income during its 1996 taxable year. It does not receive any royalties or other deductible payments during the year. It pays $90 in interest

during the same year. The interest was paid to the following persons. $30 was paid to an unrelated bank resident in Switzerland; $30 was paid to a sister corporation resident in Bermuda; and $30 was paid to an unrelated corporation resident in the Isle of Man. The income received by the Bermuda affiliate was not subject to tax in the hands of the recipient. NL-1 is a conduit company because it made payments of items classified as deductible payments equal to at least 90 percent of its receipts of such items. If it were not a conduit company, NL-1 would be entitled to the benefits of the Convention under subparagraph 1(c)(ii). Since it is a conduit company it also must satisfy the conduit base reduction test in order to be entitled to the benefits of the Convention under subparagraph 1(c).

For purposes of the conduit base reduction test, NL-1's deductible payments consist solely of the payments made to the related party in Bermuda. The payments to the unrelated Swiss bank and the Isle of Man corporation are not considered to be deductible payments because the recipients of these payments are not associated enterprises. The payment to the related Bermuda corporation is considered to be a deductible payment because the recipient is an associated enterprise and the recipient was subject to an aggregate rate of tax less that is less than 50 percent of the rate that would have applied had the income been taxed in the hands of NL-1. Thus, for purposes of the base reduction test, NL-1 is considered to have made deductible payments of $30. Since $30 is less than 50 percent of NL-1's gross income of $100 for 1996, NL-1 satisfies the base reduction test under subparagraph 5(d), and is entitled to the benefits of the Convention under subparagraph 1(c)(iv).

Shipping and Air Transport - Paragraph 6

Paragraph 6 provides that a resident of one of the States that derives income from the other State described in Article 8 (Shipping and Air Transport) and that is not entitled to the benefits of the Convention under paragraphs 1 through 5 of Article 26, shall nonetheless be entitled to the benefits of the Convention with respect to income described in Article 8 if it meets one of two tests. These tests in substance duplicate the rules set forth under Code section 883 and therefore afford little additional benefits beyond those already afforded by the Code. These tests are described below.

First, a resident of one of the States will be entitled to the benefits of the Convention with respect to income described in Article 8 if more than 50 percent of the beneficial interest in the person (in the case of a company, more than 50 percent of the value of the stock of the company) is owned, directly or indirectly by qualified persons or individuals who are residents of a third state that grants by law, common agreement, or convention an exemption under similar terms for profits as mentioned in Article 8 to

citizens and corporations of the other State. This provision is analogous to the relief provided under Code section 883(c)(1).

Alternatively, a resident of one of the States will be entitled to the benefits of the Convention with respect to income described in Article 8 if the person is a company, the stock of which is primarily and regularly traded on an established securities market in a third state, provided that the third state grants by law, common agreement, or convention an exemption under similar terms for profits as mentioned in Article 8 to citizens and corporations of the other State. This provision is analogous to the relief provided under Code section 883(c)(3). The term "primarily and regularly traded on an established securities market" is not defined in the Convention. In determining whether a resident of the Netherlands is entitled to benefits of the Convention under this paragraph, the United States will refer to the principles of Code section 883(c)(3)(A) for guidance as to the definition of this term.

Competent Authority - Paragraph 7

Paragraph 7 of Article 26 provides that a resident of one of the States that is not entitled to the benefits of the Convention with respect to income derived from the other State under any of the other provisions of Article 26 may, nevertheless, be granted benefits under the Convention at the discretion of the competent authority of the State in which the income arises.

In making determinations under paragraph 7 the competent authority of the State in which the income arises will take into account as its guideline whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Thus, persons that establish operations in one of the States with a principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief under paragraph 7. Before denying benefits, however, a competent authority is required by paragraph 7 to consult the other competent authority. In making this determination with respect to a corporation, paragraph XIX. of the Memorandum of Understanding provides that the following factors (and others) may be relevant:

(1) The date of incorporation of the corporation seeking benefits in relation to the date that the Convention entered into force;

(2) the continuity of the historical business and ownership of the corporation;

(3) the business reasons for the corporation residing in its State of residence;

(4) the extent to which the corporation is claiming special tax benefits in its country of residence;

(5) the extent to which the corporation's business activity in the other State is dependent on the capital, assets or personnel of the corporation in its State of residence; and

(6) the extent to which the corporation would be entitled to treaty benefits comparable to those afforded by the Convention if it had been incorporated in the country of residence of the majority of its shareholders.

An additional factor that might be accorded weight by the United States competent authority with respect to a Netherlands corporation include obtaining the benefit of various European Community directives for operations conducted in the EC. Further, the fact that a Netherlands corporation failed to satisfy one of the tests under the substantive rules of Article 26, but failed to do so by a narrow margin, would generally be a factor that, in combination with one or more of the factors described above, would weigh in favor of favorable consideration by the United States competent authority.

Paragraph XXI. of the Memorandum of Understanding provides an additional factor weighing in favor of favorable determinations by the competent authority in cases in which a corporation that was entitled to the benefits of the Convention under paragraphs 1 or 2 of Article 26 is no longer entitled to benefits as the result of "changed circumstances." This paragraph recognizes the legal requirements for the free flow of capital and persons within the European Communities. Changed circumstances that the competent authority may consider as a favorable factor include a change in the state of residence of a major shareholder of the company, the sale of part of the stock of a Netherlands company to a person resident in another member state of the European Communities, or an expansion of a company's activities in other member states of the European Communities, all under ordinary business conditions. If these changed circumstances affect only the distribution of a company's activities or ownership within the European Communities, and are not attributable to tax avoidance motives, the U.S. competent authority will view these changed circumstances as a factor weighing in favor of continued entitlement to benefits under paragraph 7.

In addition, paragraph XX. of the Memorandum of Understanding sets forth the understanding of the negotiators that certain mutual funds, although not entitled to the benefits of the Convention under Article 26, will be granted the benefits of the Convention if they hold stock and securities the income from which is not predominantly from sources in the other State, have widely dispersed ownership, and employ in their State of residence a substantial staff actively engaged in trades of stocks and

securities owned by the company. Moreover, if any of these factors is absent it is understood that relief under paragraph 7 will not be granted to an entity seeking to qualify as a mutual fund. This paragraph is not relevant for applying paragraph 7 to entities that are not mutual funds.

It is assumed that, for purposes of implementing paragraph 7, a taxpayer will be permitted to present his case to his competent authority for an advance determination based on the facts, and will not be required to wait until the tax authorities of one of the States have determined that benefits are denied. In these circumstances, it is also expected that if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

It is not necessary, however, for a taxpayer to obtain an advance determination under paragraph 7 in order to obtain the benefits of the Convention under this paragraph. A taxpayer confident of its ability to present a convincing case under paragraph 7 could refrain from obtaining an advance determination from the competent authority and wait to present a case to the competent authority until requested to do so by the competent authority. A person pursuing this strategy will have no assurance (apart from its confidence in its position) that the competent authority will determine that benefits of the Convention should be granted, unless that position is based on further guidance provided by the competent authorities with respect to the application of paragraph 7.

Article 27 - OFFSHORE ACTIVITIES

This Article deals exclusively with the taxation of activities carried on by a resident of one of the States on the continental shelf of the other State in connection with the exploration or exploitation of the natural resources of the shelf, principally activities connected with exploration for oil by offshore drilling rigs. In the U.S. and OECD Models, the income from these activities is subject to the standard rules found in the other Articles of the Convention (e.g., the business profits and personal services articles). Other U.S. treaties with countries bordering on the North Sea (e.g., Norway and the U.K.), however, have articles dealing with offshore activities. Netherlands treaties with its North Sea partners also contain such provisions. The prior Convention had no similar provision. The normal business profits and personal services provisions, therefore, applied under the prior Convention to offshore income.

Paragraph 1 states that the provisions of Article 27 apply notwithstanding any other provision of the Convention. Although

there are no explicit cross references to other articles, the implicit references are principally to Articles 5 (Permanent Establishment), 7 (Business Profits), 15 (Independent Personal Services) and 16 (Dependent Personal Services). For example, if a drilling rig of a U.S. enterprise is present on the continental shelf of the Netherlands for 10 months, and would, therefore, not constitute a permanent establishment because of the 12-month construction site rule of paragraph 3 of Article 5, the rig would, nevertheless, be deemed to be a permanent establishment under paragraph 3 of this Article.

Paragraph 1 further provides, however, that if activities constitute a permanent establishment or fixed base under Articles 5 or 15, Article 27 will not apply, and the income of the permanent establishment or fixed base will be taxed in accordance with the other Articles of the Convention. Because of this rule, an activity of a U.S. enterprise on the continental shelf of the Netherlands that constitutes a permanent establishment or a fixed base under Articles 5 or 15 will be taxed as provided in the Convention without reference to Article 27. Although it is unlikely that this rule would have a substantive effect with respect to the presence of a permanent establishment, since any case that would constitute a permanent establishment under Article 5 also would be a deemed permanent establishment under Article 27, it is possible for income to be taxable under Article 15 and not under Article 27. Article 27 requires a 30-day physical presence in a calendar year for income to be deemed to be attributable to a fixed base. Article 15 merely requires that a fixed base be regularly available to the performer of the services and that the income from the services be attributable to the fixed base. Thus, a work place on a rig could be deemed to be a fixed base regularly available to an individual who performs services at that work place for less than 30 days during the year. The individual's remuneration for the services performed at that work place would be taxable under Article 15, but not under Article 27.

Paragraph 2 defines the term "offshore activities" for purposes of the Article as activities that are conducted offshore in connection with the exploration or exploitation of the sea bed and its sub-soil and their natural resources, situated in one of the States.

Paragraph 3 provides the basic rule for determining when a permanent establishment is deemed to exist and when income from offshore activities is deemed to be attributable to the permanent establishment. An enterprise of one State carrying on offshore activities (subject to exceptions described in paragraph 4) in the other State will be deemed to be carrying on business through a permanent establishment situated there if the activities are carried on there for a period or periods aggregating more than 30 days in a calendar year.

Paragraph 3 also provides that if the enterprise carrying on the offshore activities is associated with another enterprise, and that associated enterprise is also carrying on offshore activities that are part of the same project, their periods of presence are aggregated to determine whether the 30 day threshold has been met. If the threshold is passed, both enterprises are deemed to have a permanent establishment under this Article. For purposes of this rule, association is defined as direct or indirect ownership of at least one-third of the capital in the other, or where one person holds, directly or indirectly, at least a one-third of the capital of both enterprises.

Paragraph 4 identifies three classes of activities that are not to be treated as "offshore activities" for purposes of taxation under paragraph 3. Subparagraph (a) excludes the activities mentioned in paragraph 4 of Article 5 that do not give rise to a permanent establishment under that Article even if they are carried on through a fixed place of business. Subparagraph (b) excludes towing or anchor handling by ships primarily designed for that purpose, and other activities performed by such ships. Subparagraph (c) excludes any transport by ships or aircraft in international traffic. The activities described in subparagraphs (a) and (c) will be exempt from tax by the host country under Articles 7 (Business Profits) and 8 (Shipping and Air Transport), respectively, whether or not the income is attributable to a permanent establishment. Activities under group (b) are subject to the normal rules of Articles 5 and 7, i.e., if the income is not attributable to a permanent establishment there will be no host country tax.

Paragraph XXVI. of the Memorandum of Understanding clarifies that when supplies or personnel are transported from one of the States to an offshore location in that State, or between two offshore locations in that State (e.g., between an onshore location and an offshore rig on that State's continental shelf, or between two offshore rigs located on the shelf), such transport will be considered to be between two places within that State, and is not, therefore, in international traffic.

Paragraph 5 sets a threshold of 30 consecutive days for the deemed existence of a fixed base and for the attribution of income from offshore activities of a professional or independent character to that fixed base. Thus, if an individual who is a resident of the United States performs independent personal services on a drilling rig on the continental shelf of the Netherlands for 30 consecutive days, his income from such services will be taxable by the Netherlands, whether or not his income was attributable to a fixed base regularly available to the individual in the Netherlands and otherwise taxable under Article 15 (Independent Personal Services) .

Paragraph 6 contains a rule for the taxation of employment

income connected with offshore activities. It provides for a broader host-country taxing right than does Article 16 (Dependent Personal Services). Under paragraph 6, salaries, etc., of a resident of one State derived from an employment in connection with offshore activities carried on through a permanent establishment (whether as a result of Article 5 or paragraph 3) in the other may be taxed by the other State. Paragraph 6 contains no special rule regarding the taxation of persons employed on ships, etc., in connection with offshore activities. Under Article 16, the presence of a permanent establishment is not sufficient to subject the employee to host country tax. Under paragraph 6 of Article 27, however, an employee merely needs to be engaged in offshore activities carried on in connection with a Netherlands permanent establishment engaged in offshore activities in the Netherlands to be subject to tax, regardless of who pays his salary and whether it is deductible in the Netherlands, and regardless of the amount of time he has spent in, or off the shore of, the Netherlands.

Paragraph 7 provides for an exemption by the Netherlands, in conformity with the rules of paragraph 2 of Article 25 (Methods of Elimination of Double Taxation), for income that is taxable in the United States under paragraphs 3, 5 or 6 of this Article. These are all classes of income that are exempt from Netherlands tax under Article 25. Paragraph 7, however, requires documentary evidence that the U.S. tax has actually been paid.

As with any benefit of the Convention, an enterprise claiming a benefit under this Article must be entitled to the benefit under the provisions of Article 26 (Limitation on Benefits).

Article 28 - NON-DISCRIMINATION

This Article assures that nationals of a State, in the case of paragraph 1, and residents of a State, in the case of paragraphs 2 through 5, will not be subject to discriminatory taxation in the other State. For this purpose, non-discrimination means providing national treatment.

Paragraph 1 provides that a national of one of the States may not be subject to taxation or connected requirements in the other State that are other or more burdensome than the taxes and connected requirements imposed upon a national of that other State in the same circumstances. A national of one of the States is afforded protection under this paragraph even if the national is not a resident of either State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same treatment in the Netherlands as a Dutch national who is in similar circumstances (i.e., who is resident in that third country). The term "national" is defined for each State in subparagraph 1(g) of Article 3 (General Definitions).

Paragraph 1 clarifies that this paragraph does not obligate the United States to apply the same taxing regime to a Netherlands national who is not resident in the United States and a U.S. national who is not resident in the United States. Paragraph 1 applies only when the nationals of the two States are in the same circumstances. United States citizens who are not residents of the United States but who are, nevertheless, subject to United States tax on their worldwide income, are not in the same circumstances with respect to United States taxation as nationals of the Netherlands who are not United States residents. Therefore, Article 28 would not entitle a Netherlands national not resident in the United States to the net basis taxation of U.S. source dividends or other investment income that applies to a U.S. citizen not resident in the United States.

Paragraph 2 provides that a permanent establishment in one of the States of an enterprise of the other State may not be less favorably taxed in the first-mentioned State than an enterprise of that first-mentioned State that is carrying on the same activities in the first-mentioned State. This provision, however, does not obligate a State to grant to a resident of the other any tax allowances, reliefs, etc., that it grants to its own residents on account of their civil status or family responsibilities. Thus, if an individual resident in the Netherlands owns a Netherlands enterprise that has a permanent establishment in the United States, in assessing income tax on the profits attributable to the permanent establishment, the United States is not obligated to allow to the Netherlands resident the personal allowances for himself and his family that would be permitted if the permanent establishment were a sole proprietorship owned and operated by a U.S. resident.

Section 1446 of the Code imposes on any partnership with income that is effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the Convention, this obligation applies with respect to a Netherlands resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraph 2. No distinction is made between U.S. and Netherlands partnerships, since the law requires that partnerships of both domiciles withhold tax in respect of the partnership shares of non-U.S. partners. In distinguishing between U.S. and Netherlands partners, the requirement to withhold on the Netherlands but not the U.S. partner's share is not discriminatory taxation, but, like other withholding on nonresident aliens, is merely a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it otherwise may be difficult for the United States to enforce its tax jurisdiction. If tax has been over-withheld, the partner

can, as in other cases of over-withholding, file for a refund. (The relationship between paragraph 2 and the imposition of the branch tax is dealt with below in the discussion of paragraph 6.)

Paragraph 3 prohibits discrimination in the allowance of deductions. When an enterprise of one of the States pays interest, royalties or other disbursements to a resident of the other State, the first-mentioned State must allow a deduction for those payments in computing the taxable profits of the enterprise under the same conditions as if the payment had been made to a resident of the first-mentioned State. An exception to this rule is provided for cases where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 12 (Interest) or paragraph 4 of Article 13 (Royalties) apply, because these provisions permit the denial of deductions in certain circumstances in respect of transactions between related persons. The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons which includes the person incurring the expense.

The rules under section 163(j) of the Code relating to earnings-stripping are not discriminatory within the meaning of paragraph 3. First, section 163(j) applies equally to interest paid to domestic or foreign related parties, as interest paid to all domestic tax-exempt entities related to the payor corporation (under a greater than 50% ownership test) is subject to the provision. Second, as noted above, paragraph 3 does not apply to payments falling under Article 9(1) or 12(5), relating to transactions not conducted in accordance with the arm's length standard. Paragraph IV. of the Memorandum of Understanding reflects the negotiators' understanding that Article 9 applies to issues relating to thin capitalization, and that adjustments to amount of a deduction for interest must be consistent with the arm's length principles of paragraph 1 of Article 9 as those principles are examined and explained in OECD publications regarding thin capitalization. The paragraph also provides the understanding that the appropriate amount of interest deduction of an enterprise may be determined not only be reference to the amount of interest deduction of the enterprise but also by reference to the overall amount of debt capital of the enterprise. The approach taken by section 163(j) is consistent with this description.

Paragraph 4 requires that a State not impose other or more burdensome taxation or connected requirements on an enterprise of that State which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other State, than the taxation or connected requirements which it imposes on other similar enterprises of that first-mentioned State.

The Tax Reform Act of 1986 ("TRA") introduced section

367(e)(2) of the Code which changed the rules for taxing corporations on certain distributions they make in liquidation. Prior to the TRA, corporations were not taxed on distributions of appreciated property in complete liquidation, although nonliquidating distributions of the same property, with several exceptions, resulted in corporate-level tax. In part to eliminate this disparity, the law now generally taxes corporations on the liquidating distribution of appreciated property. The Code provides an exception in the case of distributions by 80 percent or more controlled subsidiaries to their parent corporations, on the theory that the built-in gain in the asset will be recognized when the parent sells or distributes the asset. This exception does not apply to distributions to parent corporations that are tax-exempt organizations or, except to the extent provided in regulations, foreign corporations. The policy of the legislation is to collect one corporate-level tax on the liquidating distribution of appreciated property; if and only if that tax can be collected on a subsequent sale or distribution does the legislation defer the tax. It is understood that the inapplicability of the exception to the tax on distributions to foreign parent corporations does not conflict with paragraph 4 of the Article. While a liquidating distribution to a U.S. parent will not be taxed, and, except to the extent provided in regulations, a liquidating distribution to a foreign parent will, paragraph 4 of the Article merely prohibits discrimination among corporate taxpayers on the basis of U.S. or foreign stock ownership. Eligibility for the exception to the tax on liquidating distributions for distributions to non-exempt, U.S. corporate parents is not based upon the nationality of the owners of the distributing corporation, but is based upon whether such owners would be subject to corporate tax if they subsequently sold or distributed the same property. Thus, the exception does not apply to distributions to persons which would not be so subject -- not only foreign corporations, but also tax-exempt organizations.

For the reasons given above in connection with the discussion of paragraph 2 of the Article, it is also understood that the provision in section 1446 of the Code for withholding of tax on non-U.S. partners does not violate paragraph 4 of the Article.

It is further understood that the ineligibility of a U.S. corporation with nonresident alien shareholders to make an election to be an "S" corporation does not violate paragraph 4 of the Article. If a corporation elects to be an S corporation (requiring 35 or fewer shareholders), it is generally not subject to income tax and the shareholders take into account their pro-rata shares of the corporation's items of income, loss, deduction or credit. (The purpose of the provision is to allow an individual or small group of individuals to conduct business in corporate form while paying taxes at individual rates as if the business were conducted directly.) A nonresident alien does not pay U.S. tax on a net basis, and, thus, does not generally take into account items of loss, deduction or credit. Thus, the S corporation provisions do

not exclude corporations with nonresident alien shareholders because such shareholders are foreign, but only because they are not net basis taxpayers. The provisions also exclude corporations with other types of shareholders where the purpose of the provisions cannot be fulfilled or their mechanics implemented. For example, corporations with corporate shareholders are excluded because the purpose of the provisions to permit individuals to conduct a business in corporate form at individual tax rates would not be furthered by their inclusion.

Paragraph 5 contains a rule not found in the U.S. or OECD Models, though a similar rule appears in several other U.S. treaties. The paragraph concerns the deductibility of contributions to pension plans. It deals with an individual who is an employee and who is either a resident of one of the States or is temporarily present there, and who is not a citizen of that State. Under the paragraph, contributions by, or on behalf of, that individual to a pension plan that is recognized for tax purposes in the other State will be treated in the same manner for tax purposes in the State in which he is resident or temporarily present as a contribution to a plan that is recognized for tax purposes in that first-mentioned State. This rule applies only if (1) the individual was contributing to the plan in the other State before he became resident or temporarily present in the first-mentioned State, and (2) the competent authority of the first-mentioned State agrees that the pension plan in the other State corresponds to a recognized pension plan in the first-mentioned State. A retirement plan "recognized" for U.S. tax purposes is one that is exempt from U.S. Federal income tax. It includes, for example, a Keough Plan and an Individual Retirement Account.

Paragraph 6 of the Article specifies that no provision of the Article will prevent either State from imposing the branch tax described in Article 11 (Branch Tax). Thus, even if the branch tax were judged to violate the provisions of paragraphs 2 or 4 of the Article, neither State would be constrained from imposing the tax.

As noted above, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered), for purposes of providing nondiscrimination protection this Article applies to taxes of every kind and description imposed by a one of the States or a political subdivision or local authority thereof. Customs duties are not considered to be taxes for this purpose.

The saving clause of paragraph 1 of Article 24 (Basis of Taxation) does not apply to this Article, by virtue of the exceptions in subparagraph 2(a). Thus, a U.S. citizen who is resident in the Netherlands may claim benefits in the United States under this Article.

Article 29 - MUTUAL AGREEMENT PROCEDURE

This Article provides for cooperation between the competent authorities of the States to resolve disputes that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention. The Article also provides for the possibility of the use of arbitration to resolve disputes that cannot be settled by the competent authorities. The competent authorities of the two States are identified in subparagraph 1(i) of Article 3 (General Definitions).

Paragraph 1 provides that when a resident of one of the States considers that the actions of one or both States will result for him in taxation that is not in accordance with the Convention, he may present his case to the competent authority of his State of residence or nationality. It is not necessary for a person first to have exhausted the remedies provided under the national laws of the States before presenting a case to the competent authorities.

Paragraph 2 provides that if the competent authority of the State to which the case is presented judges the case to have merit, and cannot reach a unilateral solution, it shall seek agreement with the competent authority of the other State such that taxation not in accordance with the Convention will be avoided. If agreement is reached under this provision, it is to be implemented even if implementation is otherwise barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. Since subparagraph 2(a) of Article 1 (General Scope) provides that the Convention cannot operate to increase a taxpayer's liability, time or other procedural limitations can be overridden under this paragraph only for the purpose of making refunds and not to impose additional tax.

Paragraph 2, however, specifies that the time limits or other procedural limitations are to be overridden for purposes of implementing an agreement only if the competent authority that has been asked to waive its limits in a particular case, and has received written notification that a case exists within six years from the end of the taxable year in the other State to which the case relates. The notification may be given by the competent authority of that other State, by the taxpayer who has requested the competent authority to take action, or by a person related to that taxpayer. Although it is preferred U.S. policy to provide no time limit for the presentation of a case to the competent authorities, the limit in paragraph 2 of the Article should not result in any unreasonable denial of protection or assistance to taxpayers. The prior Convention had no such time limits.

Paragraph 3 authorizes the competent authorities to seek to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. The paragraph includes a

non-exhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement. They may agree to the same attribution of income, deductions, credits or allowances between an enterprise in one State and its permanent establishment in the other State (subparagraph a)) or between persons (subparagraph (b)). These allocations are to be made in accordance with the arm's-length principles of Article 7 (Business Profits) and Article 9 (Associated Enterprises). Paragraphs IV. and V. of the Memorandum of Understanding deal with these allocations and attributions under Articles 9 (Associated Enterprises) and Article 29. Those paragraphs are described in the explanation to Article 9.

The competent authorities also may agree to resolve bilaterally a variety of other possible conflicting applications of the Convention. They may agree to a common characterization of an item of income (subparagraph (c)), to a common application of source rules with respect to a particular item of income (subparagraph (d)) and to a common meaning of a term (subparagraph (e)). Subparagraph (f) authorizes the competent authorities to increase the dollar amounts referred to in the Convention to reflect economic and monetary developments. The dollar amounts referred to are Articles 18 (Artistes and Athletes) and 22 (Students and Trainees). If, for example, after the Convention has been in force for some time, inflation has rendered the $10,000 exemption threshold for entertainers or the $2,000 earned income exemption threshold for students or trainees unrealistically low in terms of the original objectives in setting the thresholds, the competent authorities may agree to a higher threshold without the need for formal amendment to the treaty and ratification by the States. This provision can be applied only to the benefit of taxpayers, i.e., only to increase thresholds, not to reduce them. Paragraph 3 also provides that the competent authorities may agree to the application, consistent with the objective of avoiding double taxation, of the internal laws of the Contracting States regarding penalties, fines and interest (subparagraph (g)). Agreements reached by the competent authorities under this paragraph need not conform to the internal law provisions of either Contracting State.

Finally, paragraph 3 authorizes the competent authorities to consult for the purpose of eliminating double taxation in cases not provided for in the Convention, but with respect to the taxes covered by the Convention. An example of such a case might be double taxation arising from a transfer pricing adjustment between two permanent establishments of a third-country resident, one in the United States and one in the Netherlands. Since no resident of one of the States is involved in the case, the Convention does not, by its terms, apply, but the competent authorities may, nevertheless, use the authority of the Convention to seek to prevent any double taxation.

Paragraph 4 provides that the competent authorities may communicate with each other, including, where appropriate, in face-to-face meetings of representatives of the competent authorities, for the purpose of reaching agreement under this Article.

Paragraph 5 contains an arbitration procedure found in only one other U.S. tax treaty, that with the Federal Republic of Germany, signed in 1989. Paragraph 5 provides that where the competent authorities have been unable, pursuant to paragraphs 1 through 4 of the Article, to resolve a disagreement regarding the application or interpretation of the Convention, the disagreement may, by mutual consent of the competent authorities, be submitted for arbitration, provided the taxpayer agrees in writing to be bound by the decision of the arbitration board. Nothing in the provision requires that any case be submitted for arbitration. If a case is submitted to an arbitration board, the board's decision in that case will be binding on both Contracting States with respect to that case.

The United States was reluctant to implement an arbitration procedure under another tax convention until there had been an opportunity to evaluate the process in practice under the German Convention. It was agreed, therefore, that, as specified in paragraph 5, the provisions of the Convention calling for an arbitration procedure will not take effect until the two States have agreed through an exchange of diplomatic notes to do so. This agreement is elaborated on in subparagraph A of paragraph XXVII. of the Memorandum of Understanding. That paragraph notes the understanding that the two States will exchange diplomatic notes implementing the arbitration procedure at such time as either the provision under the U.S.-Germany Convention, or the similar provision in the European Communities agreement signed on 23 July, 1990, has proven to the satisfaction of the competent authorities of both the United States and the Netherlands to be satisfactory. It is further agreed that the competent authorities will consult at the conclusion of three years following entry into force of the Convention to determine whether conditions have been fulfilled for the exchange of diplomatic notes implementing the arbitration procedure.

The arbitration procedures are to be made effective by exchanges of notes through diplomatic channels. Subparagraph B of Paragraph XXVII. of the Memorandum of Understanding specifies a set of procedures to be used in the implementation of paragraph 5. It is agreed that, in using the arbitration procedure in a specific case, the following procedures will be applied:

1. If, in applying paragraphs 1 to 4 of Article 29, the competent authorities fail to reach an agreement within two years of the date on which the case was submitted to one of the competent authorities, they may agree to invoke

arbitration in a specific case, but only after fully exhausting the procedures available under paragraphs 1 to 4 of Article 29. The competent authorities will not generally accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either State.

2. The competent authorities shall establish an arbitration board for each specific case in the following manner:

a) An arbitration board shall consist of not fewer than three members. Each competent authority shall appoint the same number of members, and these members shall agree on the appointment of the other member(s).

b) The other member(s) of the arbitration board shall be from either State or from another OECD member country. The competent authorities may issue further instructions regarding the criteria for selecting the other member(s) of the arbitration board.

c) Arbitration board member(s) (and their staffs) upon their appointment must agree in writing to abide by and be subject to the applicable confidentiality and disclosure provisions of both States and the Convention. In case those provisions conflict, the most restrictive condition will apply.

3. The competent authorities may agree on and instruct the arbitration board regarding specific rules of procedure, such as appointment of a chairman, procedures for reaching a decision, establishment of time limits, etc. Otherwise, the arbitration board shall establish its own rules of procedure consistent with generally accepted principles of equity.

4. Taxpayers and/or their representatives shall be afforded the opportunity to present their views to the arbitration board. These presentations may be either in person or in writing.

5. The arbitration board shall decide each specific case on the basis of the Convention, giving due consideration to the domestic laws of the States and the principles of international law. The arbitration board will provide to the competent authorities an explanation of its decision. The decision of the arbitration board in a particular case shall be binding on both States and the taxpayer(s) with respect to that case. While the decision of the arbitration board shall not have precedential effect, it is expected that such decisions ordinarily will be taken into account in subsequent competent authority cases involving the same taxpayer(s), the same issue(s), and substantially similar facts, and may also be taken into account in other cases where appropriate.

6. Costs for the arbitration procedure will be borne in the following manner:

a) each State shall bear the cost of remuneration for the member(s) appointed by it, as well as for its representation in the proceedings before the arbitration board;

b) the cost of remuneration for the other member(s) and all other costs of the arbitration board shall be shared equally between the States; and

c) the arbitration board may decide on a different allocation of costs.

However, if it deems appropriate in a specific case, in view of the nature of the case and the roles of the parties, the Competent Authority of one of the States may require the taxpayer(s) to agree to bear that State's share of the costs as a prerequisite for arbitration.

7. The competent authorities may agree to modify or supplement these procedures; however, they shall continue to be bound by the general principles established in these procedures.

Paragraph 6 establishes a procedure to be followed by the competent authorities in the event that one of the States applies or may apply its law in a manner that may impede the full implementation of the Convention. This provision is intended to address the possibility that changes to the law of one of the States may prevent application of the Convention as intended by the States as of the date of signature. In particular, this paragraph would apply in the case of a statutory override of the provisions of the Convention by the United States. It is unlikely to be invoked by the United States, as the Netherlands is constitutionally barred from overriding a treaty by internal legislation. The paragraph requires a competent authority that becomes aware of such application, or potential application, to inform the competent authority of the other State in a timely manner. Either State may request that the competent authorities consult with a view to establishing a basis for the full implementation of the Convention. The paragraph directs that these consultations begin within six months of the time that the competent authority of the first State advises the competent authority of the other State of the impediment to the application of the Convention.

The notes exchanged by the States at the time of the signing of the Convention dealt with the issue of treaty overrides. In the notes, the two Governments affirm both that the Convention, once in force, is binding on both parties, and their recognition of the

need to avoid legislative or interpretive overrides of treaty obligations. They also recognize, however, that changes in tax laws may affect the implementation of the Convention. In such a case, the two Governments will engage in consultations and negotiations to determine whether, and the extent to which, an amendment to the Convention is necessary and acceptable.

By virtue of the exceptions in paragraph 2(a) of Article 24 (Basis of Taxation), this Article is not subject to the saving clause of paragraph 1 of that Article. Thus, rules, definitions, procedures, etc., that are agreed upon by the competent authorities under this Article, may be applied by the States with respect to their citizens and residents even if they differ from the comparable internal law provisions. Similarly, as indicated above, internal law may be overridden by a State to provide refunds of tax to its citizens or residents under this Article.

Article 30 - EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

This Article provides for the exchange of information between the competent authorities of the States. The information to be exchanged is that which is necessary for carrying out the provisions of the Convention or the domestic laws of the United States or the Netherlands concerning the taxes covered by the Convention. The taxes covered by the Convention are those referred to in Article 2 (Taxes Covered). This provision differs from the U.S. Model, which, for purposes of exchange of information, covers all taxes imposed by the two Contracting States. Although the U.S. Model expresses the preferred U.S. position, many U.S. tax treaties depart from the Model in this respect, often due to the fact that the laws of the other treaty partner do not always permit exchange of information with respect to non-covered taxes. The Netherlands was unable to extend the coverage beyond the taxes specified in Article 2. Exchange of information with respect to domestic law is authorized insofar as the taxation under those domestic laws is not contrary to the Convention. Thus, information may be exchanged with respect to a covered tax, even if the transaction to which the information relates is a purely domestic transaction in the requesting State and, therefore, the exchange is not made for the purpose of carrying out the Convention. It is contemplated that Article 30 will be used to exchange information on a routine basis, on request in relation to a specific case, or spontaneously.

Paragraph 1 states that information exchange is not restricted by Article 1 (Personal Scope), meaning that information may be requested and provided under this Article with respect to persons who are not residents of either State. For example, if a third-country resident has a permanent establishment in the Netherlands and that permanent establishment engages in transactions with a U.S. enterprise, the United States may request

information with respect to that permanent establishment, even though it is not a resident of either State. Similarly, if a third-country resident maintains a bank account in the Netherlands, and the Internal Revenue Service has reason to believe that funds in that account should have been reported for U.S. tax purposes but have not been so reported, information can be requested from the Netherlands with respect to that person's account.

Paragraph 1 also provides assurances that any information exchanged will be treated as secret, subject to the same disclosure constraints as information obtained under the laws of the requesting State. The purposes for which information may be requested include the assessment, collection, administration, enforcement, prosecution before an administrative authority, initiation of prosecution before a judicial body, or the determination of appeals with respect to the taxes covered by the Convention. The persons authorized to receive information may disclose the information in public court proceedings or in judicial decisions. Information received may be disclosed only to persons or authorities (including courts or administrative bodies) involved in the above functions in relation to the taxes covered by the Convention. The description in the Convention of the uses to which exchanged information may be put differs in one respect from the standard U.S. tax treaty policy. It is U.S. policy to exchange information both for civil and criminal uses. The view of the Netherlands is that it is not appropriate to use a tax treaty to request information for use in a criminal proceeding. Information for such purposes should be exchanged under the U.S.- Netherlands Mutual Legal Assistance Treaty (MLAT). However, information requested at an administrative stage, for enforcement purposes, prior to the initiation of any criminal proceedings, can subsequently be used for criminal prosecution, as long as the competent authority supplying the information has given prior authorization for such use. The competent authorities may agree to waive this prior authorization condition.

Paragraph XXIX. of the Memorandum of Understanding clarifies the meaning of the term "administration" as it is used in paragraph 1 of Article 30. The Memorandum of Understanding explains that persons concerned with the administration of taxes, in the United States, include legislative bodies, such as the tax-writing committees of Congress and the General Accounting Office. These bodies are subject to the same requirements of confidentiality under the Convention as apply to any information exchanged under the Convention. Information received by these bodies is for use in the performance of their role in overseeing the administration of U.S. tax laws. This role is understood to be limited to ensuring that the administration of the tax laws by the executive branch is honest, efficient and consistent with legislative intent.

Paragraph 2 provides that when information is requested by one of the States in accordance with this Article, the other State

is obligated to obtain the requested information as if the tax in question were the tax of the requested State, even if that State has no direct tax interest in the case to which the request relates. The paragraph further provides that the requesting State may specify the form in which information is to be provided (e.g., depositions of witnesses and authenticated copies of original documents) and that the requested State shall provide the information in the form requested to the same extent that it can obtain information in that form under its own laws and administrative practices with respect to its own taxes.

Paragraph 3 relates to the disclosure provisions of Article 30 and to the arbitration provisions of paragraph 5 of Article 29 (Mutual Agreement Procedure). When a case is referred to an arbitration board, confidential information necessary for carrying out the arbitration procedure may be released by the States to the board. The members of the board, and any staff, however, are subject to the disclosure rules of paragraph 1 of this Article. The release of information to the arbitration board is subject to the provisions of paragraph 2 of this Article, and to the provisions of Article 32 (Limitation of Articles 30 and 31). Thus, if an arbitration board requests information in a particular form, the requested state should endeavor (as provided in paragraph 2) to provide the information in the form requested. However, the requested State is not required to carry out administrative measures at variance with its own laws in order to provide the information (as provided in Article 32).

The limitations on the obligations of a State to provide information, that are found in the information exchange article in the U.S. and OECD Models, are set forth in Article 32 (Limitation on Articles 30 and 31) in the Convention.

Paragraph XXVIII. of the Memorandum of Understanding clarifies the relationship between Article 30 and the reporting requirements of Code sections 6038A and 6038C. The paragraph specifies when the Internal Revenue Service will request information under Article 30 of the Convention before seeking the information under those Code rules. The paragraph provides that if a U.S. "reporting corporation" (as defined for purposes of Code section 6038A) that is a U.S. resident, or a U.S. permanent establishment of a U.S. reporting corporation that is not a U.S. resident, has neither possession of nor access to records that may be relevant to the U.S. income tax treatment of any transaction between it and a foreign "related party" (as defined in Code section 6038A), and such records are under the control of a Netherlands resident and are maintained outside the United States, then the United States shall request such records from the Netherlands through an exchange of information under Article 30 before issuing a summons for such records to the United States reporting corporation, provided that under all the circumstances presented, the records will be obtainable through the request on a

timely and efficient basis. For this purpose, records will be considered to be available on a timely and efficient basis if they can be obtained within 180 days of the request or such other period agreed upon in mutual agreement between the competent authorities, except where the statute of limitations may expire in a shorter period. Similar principles apply with respect to requests for information under Code section 6038C. This provision is consistent with the provisions of the regulations under section 6038A (see, Treas. Reg. §1.6038A-6(b)), and the legislative history of the provision, which expressed a concern that the IRS not be required to use treaty information exchange procedures when information was not available on a timely basis or when the statute of limitations was about to expire.

Paragraph XXVIII. of the Memorandum of Understanding also provides guidance on another aspect of information exchange. Under the terms of this paragraph, the competent authority of one of the States will, in applying the "conduit base reduction test" of subparagraph 5(d) of Article 26 (Limitation on Benefits), limit its requests for information initially to that information necessary to determine whether the subject of the request is a "conduit company," as defined in subparagraph 8(m) of Article 26. Only if it determines that the company is a conduit company, will it then request additional information necessary to determine whether that company has satisfied the conduit base reduction test.

Article 31 - ASSISTANCE AND SUPPORT IN COLLECTION

This Article is essentially the same as Article XXII of the prior Convention. Under paragraphs 1 through 3, the States agree to lend assistance in collection of the taxes that are the subject of the Convention, along with interest, costs, additions to the taxes and non-penal fines. The taxes to be collected must be finally determined in the requesting State, as established by documents accompanying the request. The requested State will use the procedures that it uses in the collection of its own taxes, but will not be required to enforce executory measures for which there is no provision in the law of the requesting State.

Paragraph 4 provides that assistance will not be granted with respect to citizens, corporations or other entities of the requested State, except to the extent necessary to ensure that the benefits of the Convention are enjoyed only by persons entitled to those benefits under the terms of the Convention. Under the paragraph, assistance will be provided in those cases where the competent authorities agree that an exemption or reduced rate of tax at source granted under the Convention by that other State has been enjoyed by persons not entitled to those benefits.

Article 32 (Limitations on Articles 30 and 31) makes clear that the State asked to collect the tax is not obligated, in the

process, to carry out administrative measures that are different from those used in the collection of its own taxes.

Paragraph XXX. of the Memorandum of Understanding specifies the agreed rules for the application of Article 31. It provides as follows:

1. The requested State shall not be obliged to accede to the request of the applicant State:

(a) if the applicant State has not pursued all appropriate collection action in its own jurisdiction;

(b) in those cases where the administrative burden for the requested State is disproportionate to the benefit to be derived by the applicant State.

2. The request for administrative assistance in the recovery of a tax claim shall be accompanied by:

(a) an official copy of the instrument permitting enforcement in the applicant State;

(b) where appropriate, certified copies of any other document required for recovery;

(c) a certification by the competent authority of the applicant State that, under the laws of that State, the revenue claim has been finally determined.

For the purposes of this Article, a revenue claim is finally determined when the applicant State has the right under its internal law to collect the revenue claim and all administrative and judicial rights of the taxpayer to restrain collection in the applicant State have lapsed or been exhausted.

3. A revenue claim of the applicant State that has been finally determined may be accepted for collection by the competent authority of the requested State and, subject to the provisions of paragraph 7, if accepted shall be collected by the requested State as though such revenue claim were the requested State's own revenue claim finally determined in accordance with the laws applicable to the collection of the requested State's own taxes.

4. Where an application for collection of a revenue claim in respect of a taxpayer is accepted:

(a) by the United States, the revenue claim shall be treated by the United States as an assessment under United States laws against the taxpayer as of the time the application is received; and

(b) by the Netherlands, the revenue claim shall be treated by the

Netherlands as an amount payable under appropriate Netherlands law, the collection of which is not subject to any restriction.

5. Nothing in this Article shall be construed as creating or providing any rights of administrative or judicial review of the applicable State's finally determined revenue claim by the requested State, based on any such rights that may be available under the laws of either State. If, at any time pending execution of a request for assistance under this Article, the applicant State loses the right under its internal law to collect the revenue claim, the competent authority of the applicant State shall promptly withdraw the request for assistance in collection.

6. Subject to this paragraph, amounts collected by the requested State pursuant to this Article shall be forwarded to the competent authority of the applicant State. Unless the competent authorities of the States otherwise agree, the ordinary costs incurred in providing collection assistance shall be borne by the requested State and any extraordinary costs so incurred shall be borne by the applicant State.

7. The requested State may allow deferral of payment or payment by installments, if its laws or administrative practice permit it to do so in similar circumstances, but it shall first inform the applicant State. Any interest received by the requested State as a result of the allowance of a deferral of payment or payment by installments will be transferred to the competent authority of the applicant State.

8. A revenue claim of an applicant State accepted for collection shall not have in the requested State any priority accorded to the revenue claims of the requested State.

9. The competent authorities may under this article grant assistance in collecting any tax deferred by operation of paragraph 8 of Article 14 (Capital Gains).

10. The competent authorities of the Contracting States shall agree upon the mode of application of this Article.

Article 32 - LIMITATION OF ARTICLES 30 AND 31

Article 32 contains certain rules regarding the application of Articles 30 (Exchange of Information and Administrative Assistance) and 31 (Assistance and Support in Collection). The Article explains that the obligations undertaken in the two Articles to exchange information and to lend collection assistance do not require a State to carry out administrative measures that are at variance with the laws or administrative practices of either State. Nor does the Article require a State to supply information not obtainable under the laws or administrative practices of either

State, or to disclose trade, business, industrial, commercial or professional secrets, trade processes, or other information, the disclosure of which would be contrary to public policy. Either State may, however, at its discretion, subject to the limitations of Articles 30 and 31 and its internal law, provide information or give collection assistance that it is not obligated to provide under the provisions of this Article.

Article 33 - DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Paragraph 1 provides that any fiscal privileges to which diplomatic or consular officials are entitled under general provisions of international law or under special agreements will apply notwithstanding any provisions to the contrary in the Convention.

Under paragraph 2, an individual who is a member of a diplomatic mission or consular post of one of the States and who is a national of that State, whether that mission or consular post is situated in the other Contracting State or in a third State, will be deemed to be a resident of the sending State if the individual is liable in the sending State to the same income tax obligations as are residents of that State. Residence as determined under this paragraph will apply notwithstanding any result to the contrary from the application to such individual of the rules of Article 4 (Resident).

Paragraph 3 clarifies that the Convention does not apply to international organizations or to organs or officials of such organizations, or to members of diplomatic missions or consular posts of third States present in a State, if such persons are not liable to the income tax obligations of residents in either State.

The saving clause of paragraph 1 of Article 24 (Basis of Taxation) does not, by virtue of the exception in paragraph 2(b) of Article 24, apply to override any benefits of this Article available to an individual who is neither a citizen of one of the States nor, in the case of the United States, has immigrant status there.

Article 34 - REGULATIONS

Paragraphs 1 through 3 of Article 34 specify certain procedures and practices that may be exercised by the competent authorities. Paragraph 1 authorizes the competent authorities, by mutual agreement, to determine the mode of application of Articles 10 (Dividends), 11 (Branch Tax), 12 (Interest), 13 (Royalties) and 26 (Limitation on Benefits). For example, the competent authorities may decide whether reduced rates of tax at source on items dealt with in those Articles should be granted by withholding

agents at the time payment is made, and, if so, what documentation may be required, or whether full tax may be withheld and treaty benefits granted after the fact by means of refunds. Paragraph 2 authorizes the competent authorities to agree on procedures for exchange of information and assistance in collection. These agreements may relate to such matters as forms for communication both with taxpayers and between competent authorities, currency conversion, transfer of amounts collected between tax authorities and minimum amounts subject to collection. Under paragraph 3, each competent authority may prescribe regulations in accordance with the internal law and practice in its State, for carrying out other provisions of the Convention.

These three paragraphs confirm what is implicit in the general grant of authority to the competent authorities in Article 29 (Mutual Agreement Procedure) and other Articles of the Convention.

Paragraph 4 provides a rule for the refund of tax when tax has been withheld at source in excess of the amount provided for under the Convention. It specifies that application for refund must be made to the competent authority of the State that has levied the tax within three years after the expiration of the calendar year in which the tax has been levied.

Article 35 - EXEMPT PENSION TRUSTS

This Article provides for exemption from tax by the source State of dividend and interest income earned by certain pension trusts resident in the other State. Such rules are not typically found in U.S. tax treaties, although the U.S.-Canada treaty contains essentially the same provision. There is no comparable provision in the prior Convention. Since interest income is generally exempt from source State taxation pursuant to Article 12 (Interest), a pension fund described in Article 35 will be exempt from source State taxation on interest unless such interest is attributable to a permanent establishment or fixed base in the source State.

Article 35 may extend U.S. tax benefits to some Netherlands tax-exempt organizations that they could not enjoy if they were organized in the United States, because they would not fulfill all the requirements of U.S. law to be treated as tax-exempt organizations. Similarly, some U.S. tax-exempt organizations may be entitled to Netherlands tax benefits under Article 35 that they could not enjoy if they were organized in the Netherlands because they could not qualify as tax-exempt organizations in the Netherlands. Conversely, some Dutch taxpayers that would qualify as tax-exempt organizations under U.S. law may not be so qualified under Dutch law and therefore will be unable to obtain the benefits of this Article with respect to U.S.-source dividend income. The

same is true with respect to United States pension funds investing in the Netherlands. Unlike a unilateral U.S. extension of U.S. tax benefits to Netherlands organizations, this provision extends U.S. benefits in exchange for a _quid pro quo_ in the form of equivalent benefits for similar U.S. organizations. This approach is a reasonable way to relieve an administrative burden that otherwise would be imposed if an organization were obligated to qualify as tax-exempt under the laws of both States.

Paragraph 1 provides that a trust, company or other organization, resident in one of the States, and constituted and operated exclusively to administer or provide benefits under one or more funds or plans established to provide pension, retirement or other employee benefits, is exempt from tax on its dividend and interest income arising in the other State, if the income of the organization is generally exempt from tax in the State in which it is resident. In determining whether a pension fund satisfies the requirement that it be constituted and operated "exclusively" to administer or provide benefits of the type described, the source of the entity's income will not be relevant. Rather, the use to which the entity's income is put will be dispositive. Thus, a pension fund that carries on investment and administrative activities incidental to its purpose of providing pension and other benefits shall not be considered to have failed to meet the requirement that it be constituted and operated "exclusively" for such purposes as a result of having performed such activities. In addition, although by operation of paragraph 2 dividends that are attributable to a trade or business are not entitled to the exemption described in paragraph 1, the receipt of such dividends would not result in a pension fund being deemed to have failed to operate "exclusively" to administer or provide benefits.

Section 897(h) of the Code provides that distributions by Real Estate Investment Trusts to nonresident alien individuals or foreign corporations are treated as gain recognized by such nonresident alien individual or foreign corporation from the sale or exchange of a United States real property interest. Such distributions consequently are not treated as dividends for purposes of the Convention and are subject instead to Article 14 (Capital Gains). Article 6 of the Protocol confirms this result with respect to capital gains dividends received by exempt pension trusts, providing that Article 35 does not apply to such distributions.

Paragraph 2 qualifies the exemption provided in paragraph 1 by providing that it does not apply with respect to income of such an organization that is derived from carrying on a trade or business, or that is received from a related person, other than from another exempt pension trust of the type described in paragraph 1. In the United States, whether an exempt pension trust is carrying on a trade or business generally will be determined under the rules of section 367(a)(3) of the Code. In addition,

income will be considered to be derived from carrying on a trade or business for this purpose if the income is unrelated business taxable income as defined in Code section 512. Thus, excess inclusions with respect to a residual interest in a REMIC are treated as income from carrying on a trade or business pursuant to Code section 860E(b) and therefore are included in the income described in paragraph 2.

Paragraph VIII. of the Agreed Minutes to the Protocol provides the understanding of the negotiators that for purposes of paragraph 2, a person will be considered to be a "related person" if more than 80 percent of the vote or value of any class of shares is owned by the person deriving the income.

The benefits provided by this Article are subject to the provision of Article 26 (Limitation on Benefits). Subparagraph 1(e) of Article 26 provides that a not-for-profit organization that is, by virtue of that status, generally exempt from tax in its State of residence, will be entitled to benefits if more than half of its beneficiaries, members or participants are entitled to the benefits of the Convention under paragraph 1 of the Article or are U.S. citizens. Thus, a Dutch pension plan, more than half of the members of which are individual residents of the Netherlands will be entitled, under Article 26, to the benefits of Article 35. In addition, a pension plan may be entitled to the benefits of the Convention as a result of its sponsorship by an entity that is itself entitled to the benefits of the Convention (as described in subparagraph 8(j) of Article 26).

Article 36 - EXEMPT ORGANIZATIONS

Article 36 provides for reciprocal exemption for the income of certain exempt organizations in addition to those dealt with in Article 35 (Exempt Pension Trusts). This Article does not reflect standard U.S. treaty policy, although similar provisions are found in several other U.S. tax treaties. There is no comparable provision in the prior Convention.

Paragraph 1 provides that a trust, company or other organization resident in one of the States that is operated exclusively for religious, charitable, scientific, educational or public purposes (such as an entity described in Code section 501(c)(3)) will be exempt from tax in the other State in respect of items of income if two conditions are met. The two conditions are (1) that the entity be exempt from tax in its State of residence, and (2) that the entity would be exempt from tax on such items of income in the other State, under its laws, if the company or organization were organized in that other State and carried on all of its activities there. As under Article 35, the source of an entity's income is not relevant in determining whether an entity is operated exclusively for one of the enumerated purposes.

Paragraph 2 qualifies the exemption provided in paragraph 1 by providing that it does not apply with respect to income of such an entity that is derived from carrying on a trade or business, or that is received from a related person, other than from another entity of the type described in paragraph 1. The terms trade or business and related person under this paragraph will be defined consistently with the definitions of those terms under Article 35.

Paragraph 3 provides that the competent authorities will develop procedures to implement the Article.

The benefits provided by this Article are subject to the provisions of Article 26 (Limitation on Benefits). Subparagraph 1(e) of Article 26 provides rules for determining whether a not-for-profit organization is entitled to the benefits of the Convention.

Article 37 - ENTRY INTO FORCE

This Article specifies the procedures for bringing the Convention into force and giving effect to its provisions. Paragraph 1 provides that the States each apply their required constitutional ratification procedures and notify the other in writing that those procedures have been complied with. The Convention will enter into force on the thirtieth day after the date of the later of the notifications. With respect to taxes payable at source, the rules of the Convention will have effect for payments made on or after the first day of January of the year following entry into force. For other taxes, the Convention will have effect for taxable years or periods beginning on or after the first day of January of the year following entry into force.

Paragraph 2 provides a general exception to the effective date rules of paragraph 1. Under this paragraph, if the prior Convention would have afforded greater relief from tax to a person entitled to its benefits than would be the case under this Convention, that person may elect to remain subject to all of the provisions of the prior Convention for a twelve-month period from the date on which this Convention would have had effect under the provisions of paragraph 1 of this Article. Under the election, all of the provisions of the prior Convention must be applied for that additional year. Although a person ordinarily must be entitled to the benefits of Convention under Article 26 (Limitation on Benefits) in order to claim a benefit under the Convention, a person not so entitled may nonetheless claim the benefits afforded by this paragraph. During the period in which the election is in effect, the provisions of the prior Convention will continue to apply only insofar as they applied prior to the entry into force of the Convention.

Paragraph 3 provides that the prior Convention will cease to

have effect when the provisions of this Convention take effect in accordance with paragraphs 1 and 2 of the Article. Thus, for a person not taking advantage of the election in paragraph 2, the prior Convention will cease to have effect at the time, on or after January 1 of the year following entry into force of the Convention, when the provisions of the new Convention first have effect. For persons electing the additional year of coverage of the prior Convention, the prior Convention will remain in effect for one additional year beyond the date specified in the preceding sentence. Paragraph 4 makes clear that the entry into force of the new Convention and the termination of the prior Convention will not have any effect on the applicability of any extensions of the prior Convention. Thus, the limited application of the prior Convention, according to Article XVII of that Convention, to interest flows between the United States and the Netherlands Antilles and between the United States and Aruba will continue, notwithstanding the termination of the prior Convention.

Article 7 of the Protocol provides that the provisions of the Protocol shall enter into force on the later of the dates on which the respective Governments have notified each other in writing that the formalities constitutionally required in their respective States have been complied with, and its provisions shall have effect for taxable years and periods beginning on or after the first day of January in the year following the date of entry into force of the Convention. Since the Protocol modifies the provisions of the Convention, a taxpayer that makes the election described under paragraph 2 of Article 37 will not be subject to the provisions of the Protocol until subject to the Convention itself. Conversely, a taxpayer that does not make the election described in paragraph 2 would be subject to the Protocol from the same date that the Convention was applicable to such person.

Paragraph 2 of Article 7 of the Protocol provides that notwithstanding the provisions of paragraph 1, the Protocol provisions relating to the so-called "triangular case" (Articles 1 and 2 and paragraph 2 of Article 4 of the Protocol) will have effect for payments made on or after the 30th day after the date on which the Protocol has entered into force. As with the other provisions of the Protocol, taxpayers electing the prior Convention will not be subject to these provisions until subject to the Convention itself.

Article 38 - TERMINATION

The Convention is to remain in effect indefinitely, unless terminated by one of the States in accordance with the provisions of this Article. The Convention may be terminated by either State at any time after 5 years from the date of its entry into force, provided that at least six months' prior written notice has been given through diplomatic channels. If notice is given on or before

June 30 of a calendar year (assuming the 5-year requirement has been met) the termination will have effect for taxable years or periods beginning, or, with respect to withholding taxes, for payments made, on or after January 1 of the calendar year following the year in which notice is given.

Nothing in Article 38, which relates to unilateral termination by one of the States of the Convention, should be construed as preventing the Contracting States from entering into a new bilateral agreement that supersedes, amends or terminates provisions of the Convention either prior to the expiration of the five year period or without the six month notification period.

UNITED STATES TREASURY DEPARTMENT'S TECHNICAL EXPLANATION OF THE SECOND PROTOCOL AMENDING THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE STATE OF ISRAEL WITH RESPECT TO TAXES ON INCOME SIGNED ON JANUARY 26, 1993

The Second Protocol ("the Protocol"), signed at Jerusalem on January 26, 1993, amends the Convention Between the Government of the United States of America and the Government of the State of Israel with respect to Taxes on Income, signed on November 20, 1975, as amended by the Protocol signed on May 30, 1980, ("the Convention"). This technical explanation is an official guide to the Protocol. It reflects policies behind particular provisions, as well as understandings reached with respect to the interpretation and application of the Protocol. The technical explanation is not intended to provide a complete comparison between the Protocol and the Articles of the Convention that it amends.

The Protocol was accompanied by notes, signed at the time of the signature of the Protocol (the "Exchange of Notes), indicating the views of the negotiators and the Contracting States with respect to a number of the provisions of the Protocol. In the discussions of each of the Articles of the Protocol in this explanation, the relevant portions of the Exchange of Notes also are discussed.

ARTICLE I

Article I of the Protocol amends Article 1 (Taxes Covered) of the Convention. Paragraph 1 of Article I of the Protocol amends subparagraph (a) of paragraph (1) of Article 1 of the Convention in two respects. In referring to the U.S. Internal Revenue Code ("Code"), it replaces the words "Internal Revenue Code" with the words "Internal Revenue Code of 1986". This change reflects the fact that the Tax Reform Act of 1986 ("TRA") was enacted after the date of signature of the Convention. The Convention covers both existing taxes, and taxes substantially similar to those existing taxes that are enacted after the date of signature of the Convention. The TRA introduced certain taxes into the Code that, arguably, are not substantially similar to those in the pre-1986 Code (e.g., branch profits tax and gross basis tax on shipping profits). In order to make certain that these taxes are covered by the Convention as amended by the Protocol, subparagraph (a) of paragraph (1) is changed to clarify that the base against which any new taxes are judged is the Internal Revenue Code of 1986.

The second change in subparagraph (a) is the addition of the words "but excluding social security taxes" to the description of

the U.S. taxes covered. This change, introduced at Israel's request, conforms the Convention to U.S. policy, which is not to cover social security taxes in tax treaties, but to reserve coverage of those taxes to social security totalization agreements. There is no such agreement in force between the United States and Israel. Because of the exclusion of social security taxes, for example, if an Israeli resident earns personal service income during a temporary visit to the United States, and his remuneration is exempt from U.S. income tax under one of the personal services provisions of the Convention, whether he will be subject to social security taxes will be determined, independent of the Convention, under the rules of U.S. law. The exclusion of social security taxes from the coverage of the Convention does not affect the taxation of social security benefits, which are dealt with in Article 21 (Social Security Payments) of the Convention.

Paragraph 2 of Article I of the Protocol modifies the description of the Israeli taxes covered for purposes of the Convention. The changes conform the coverage under the Convention to current Israeli law. After the Protocol's amendments, the income taxes covered in the case of Israel are the taxes imposed by the Israeli Income Tax Ordinance, by the Land Appreciation Tax Law, by the Income Tax Law (Adjustments for Inflation), and other taxes on income administered by the Government of Israel. This latter category is defined to include, but is not limited to, the profit tax on banking institutions and insurance companies, and the income tax component of a compulsory loan. Paragraph 1 of the Exchange of Notes clarifies that "other taxes on income administered by the Government of Israel" includes only taxes that are imposed solely under Israeli law.

Paragraph 3 of Article I of the Protocol replaces paragraph (3) of Article 1 of the Convention. This paragraph defines the tax coverage of the Convention for purposes of Article 27 (Nondiscrimination). Under the Protocol, in conformity with standard U.S. treaty policy, the nondiscrimination protection of the Convention will apply to all taxes imposed at all levels of Government -- by the Contracting States, or by a state or political subdivision of a state. Paragraph 2 of the Exchange of Notes confirms that the coverage includes taxes imposed by local authorities.

ARTICLE II

Article II of the Protocol amends Article 3 (Fiscal Residence) of the Convention. Paragraph 1 of Article II of the Protocol adds a new subparagraph (c) to paragraph (1) of Article 3, clarifying the circumstances under which a U.S. citizen or "green card" holder is to be treated, for purposes of the Convention, as a U.S. resident. The new subparagraph (c) provides that a U.S. citizen or green card holder, who is not, under the provisions of this Article, a resident of Israel, will be treated as a resident of the

United States for purposes of the Convention, and, thereby, entitled to treaty benefits, only if he has a substantial presence, permanent home or habitual abode in the United States. If such a person is a resident both of the United States and of Israel, whether he is to be treated as a resident of the United States or Israel for purposes of the Convention is determined by the tie-breaker rules of paragraph (2) of the Article. If, however, he is resident in the United States and not Israel, but has ties to a third State, in the absence of subparagraph (c), he would always be a resident of the United States, no matter how tenuous his relationship with the United States relative to that with the third State. For example, an individual resident of Mexico who is a U.S. citizen by birth, or who is a Mexican citizen and holds a U.S. green card, but who, in either case, has never lived in the United States, would not, under this rule, be entitled to Israeli benefits under the Convention. On the other hand, a U.S. citizen employed by a U.S. corporation who is transferred to Mexico for two years but who maintains a permanent home or habitual abode in the United States would be entitled to treaty benefits under this rule.

Paragraph 3 of the Exchange of Notes clarifies the meaning of the term "a person resident in Israel", as the term is used in subparagraph (a)(ii) of paragraph (1) of Article 3 (Fiscal Residence) of the Convention. The term is understood to refer to persons on whom taxes are imposed by Israel pursuant to the Income Tax Ordinance on income from sources outside Israel by virtue of their being Israeli citizens.

Paragraph 2 of Article II of the Protocol amends subparagraph (a) of paragraph (2) of Article 3 of the Convention to correct a cross-reference to a section of the Israeli Income Tax Ordinance that had changed from section 9(16) to section 35 between the time of the signing of the Convention and the negotiation of the Protocol.

Paragraph 3 of Article II of the Protocol amends paragraph (3) of Article 3 of the Convention. The paragraph defines the extent to which dual residents, other than individuals, are to be treated as resident in one of the Contracting States for purposes of the Convention. Under the Convention, the provision applies to dual resident corporations. The Protocol broadens to coverage to all non-individual dual residents. A corporation is resident in the United States if it is created or organized under the laws of the United States or a political subdivision. Under Israeli law a corporation is treated as a resident of Israel if it is either established there or managed and controlled there. Dual corporate residence, therefore, can arise if a U.S. corporation is managed in Israel. Under paragraph (3), the competent authorities are first to seek to settle the question of that person's residence by mutual agreement, and determine how the Convention is to apply to that person. Unless or until the competent authorities make such a determination, however, the person is not to be treated as a

resident of either Contracting State, except for purposes of certain specified Articles. Such persons may claim the benefits of the foreign tax credit under Article 26 (Relief from Double Taxation), and of protection against discrimination under Article 27 (Nondiscrimination). Thus, a dual-resident corporation may claim double taxation relief in one or both of the Contracting States that tax its worldwide income, and neither Contracting State can discriminate against a dual-resident corporation.

Since it is only for the purposes of deriving treaty benefits that such non-individual dual residents are excluded from the Convention, they may be treated as resident for other purposes, such as for determining whether treaty benefits should attach to payments made by such persons. For example, if a dual-resident corporation pays a dividend to a resident of Israel, the U.S. paying agent would withhold on that dividend at the appropriate treaty rate, since reduced withholding is a benefit enjoyed by the resident of Israel, not by the dual resident. The dual-resident corporation which is the payor of the dividend would, for this purpose, be treated as a resident of the United States under the Convention. Paragraph 3, therefore, provides that a non-individual dual resident shall be treated as a resident for purposes of payments of dividends, interest, and royalties by such persons, under paragraph 2 of Article 12 (Dividends), paragraphs (2) and (3) of Article 13 (Interest), and paragraph (1)(b) of a 14 (Royalties). Since information exchange under Article 29 (Exchange of Information and Administrative Assistance) is not limited to residents of the Contracting States, information can be exchanged about dual residents. To the extent that the Convention is relevant for dual-residents it must enter into force for such purposes. Therefore, Article 31 (Entry Into Force) also applies to dual-resident corporations.

Paragraph 4 of the Exchange of Notes applies to paragraph (3) of Article 3. It clarifies the fact that when one of the provisions of the Convention applies to a dual resident, any other provision necessary to give effect to that provision will also apply. For example, as noted above, a dividend paid by a dual-resident corporation to a resident of one of the Contracting States is entitled to the benefit of the reduced rate of tax at source. The source rule in paragraph (1) of Article 4 (Source of Income) will apply to determine the source of a dividend for this purpose, even though Article 4 is not specified in paragraph (3) of Article 3 (Fiscal Residence).

ARTICLE III

Article III of the Protocol amends two of the source rules in Article 4 (Source of Income) of the Convention. Both changes are technical changes necessary to conform the source rules to the substantive taxing rules of the Convention as they are amended by

the Protocol. Paragraph 1 of Article III amends the source rule for gain from the sale or exchange of personal property to make the source rule for gain on the disposition of corporate shares reciprocal. This change conforms the source rule to the rule in Article 15 (Capital Gains) for the taxation of gain on the disposition of corporate shares, which is amended by Article X of the Protocol to make it apply reciprocally. As provided in paragraph 3 of Article XIII of the Protocol, this source rule applies notwithstanding the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Paragraph 5 of the Exchange of Notes relates to paragraph 1 of Article III of the Protocol. It notes that, in applying the rules of the Convention to gain received by a U.S. resident on the disposition of shares in an Israeli corporation, section 865(h) of the Code may be applied to limit the foreign tax credit allowed to the U.S. resident on a per-item of income basis.

Paragraph 2 of Article III of the Protocol amends paragraph (7) of Article 4 of the Convention to conform the language of the source rule for Government remuneration, dealt with in Articles 21 (Social Security Payments) and 22 (Governmental Functions), to the broadened definition of the term "public funds of one of the Contracting States" in Article 22, resulting from Article XI of the Protocol.

ARTICLE IV

Article IV of the Protocol amends paragraph (5) of Article 5 (Permanent Establishment) of the Convention to conform the rule of the paragraph to that reflected in the current U.S., U.N. and OECD Model Conventions. As amended by the Protocol, paragraph (5) provides that a dependent agent of a resident of a Contracting State will constitute a permanent establishment in the other Contracting State if the agent has, and habitually exercises in the other State, the authority to conclude contracts in the name of the resident, unless his activities are of the type that would not give rise to a permanent establishment under the provisions of paragraph (3) of Article 5.

ARTICLE V

Article V of the Protocol amends Article 6 (General Rules of Taxation) of the Convention in several respects. Paragraph 1 of Article V of the Protocol conforms the rule of paragraph (3) of Article 6 to current U.S. treaty policy regarding the treatment of former U.S. citizens. It provides that, for purposes of the saving clause in paragraph (3), a citizen of a Contracting State includes a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax. Such a former citizen is

to be treated as a citizen for this purpose only for a period of 10 years following the loss of citizenship. In the United States, such a former citizen is taxable in accordance with the provisions of section 877 of the Code for 10 years following the loss of citizenship. The paragraph also provides for consultation by the competent authorities on the purposes of an individual's loss of citizenship.

Paragraph 2 of Article V of the Protocol amends subparagraph (a) of paragraph (4) of Article 6 of the Convention, which contains exceptions to the saving clause. The source State's exemptions of alimony and annuities, and the residence State exemption for child-support payments, in paragraph (2) and (3), respectively, of Article 20 (Private Pensions and Annuities), are added to the general exceptions to the saving clause.

Paragraph 3 of Article V of the Protocol amends paragraph (6) of Article 6 (General Rules of Taxation) of the Convention. Paragraph (6) contains a so-called "remittance basis" rule, under which source-country relief under the Convention applies only to that portion of an item of income that is remitted to the residence country, if the rule in the residence country is to subject to tax only the remitted income. Under the Convention the income must be remitted during the year in which the income accrues. The Protocol modifies this rule to allow source relief if the income is remitted during the year of accrual or during the first three months of the following year. This amendment permits relief from source-country tax even in cases where there is a short time lag between the time of accrual of the income and the time it is remitted that may extend into the next taxation year.

Paragraph 4 of Article V of the Protocol adds two new paragraphs to Article 6 (General Rules of Taxation) of the Convention. The new paragraphs are designated as paragraphs (7) and (8), and the existing paragraph (7) becomes paragraph (9).

The new paragraph (7) elaborates on paragraph (8) of Article 4 (Source of Income), paragraphs (1) and (2) of Article 8 (Business Profits), paragraph (5) of Article 12 (Dividends), paragraph (5) of Article 13 (Interest), paragraph (3) of Article 14 (Royalties), and subparagraph (c) of paragraph (1) of Article 15 (Capital Gains). This paragraph incorporates the principle of Code section 864(c)(6) into the Convention. Like the Code section on which it is based, the new paragraph (7) provides that any income or gain attributable to a permanent establishment (or, in the context of Articles 12, 13 and 14, a fixed base as well) during its existence is taxable in the Contracting State where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) no longer exists.

The new paragraph (8) is intended to deal with changes in law or in treaty policy of either of the Contracting States, that have

the effect of changing the application of the Convention in a significant manner or that alter the relationship between the Contracting States. Paragraphs 6 and 7 of the Exchange of Notes elaborate the procedures established in paragraph (8) of the Article. Paragraph (8) provides, first, that, in response to a change in the law or policy of either State, the appropriate authority of either State may request consultations with its counterpart in the other State to determine whether a change in the Convention is appropriate. The "appropriate authorities" may be the Contracting States themselves, communicating through diplomatic channels, or they may be the competent authorities under the Convention, communicating directly. The request for consultations may come either from the authority of the Contracting State making the change in law or policy, or it may come from the authority of the other State. If the authorities determine, on the basis of the consultations, that a change in domestic legislation has significantly altered the balance of benefits provided by the Convention, they will endeavor, promptly, to amend the Convention to restore an appropriate balance. The authorities also may consult regarding a change in treaty policy or domestic law by one of the Contracting States. The purpose of these consultations would be to determine whether the change in policy should result in amendment of the Convention.

Paragraph 7 of the Exchange of Notes provides several examples of the kinds of unilateral changes that may prompt a decision to seek to negotiate amendments to the Convention. Such a decision may result from the granting by one of the Contracting States of favorable benefits to a third country, such as an agreement to liberalize the foreign tax credit granted by treaty. Another example provided in the Exchange of Notes is the granting to a third-country partner of corporate/shareholder integration benefits. Paragraph 7 of the Exchange of Notes also suggests that, as long as the U.S.-Israel Free Trade Agreement remains in force, if one Contracting State treats expenses, for example research and development expenses, incurred within that State more favorably than the same expenses incurred within the other State, such a change would lead to consultations regarding possible amendments to the Convention.

Paragraph 6 of the Exchange of Notes states the agreement of the Contracting States that if the United States grants tax sparing credits under agreement with any other country, the Convention will be amended promptly to incorporate such a provision.

ARTICLE VI

Article VI of the Protocol amends Article 7 (Income from Real Property) by replacing the text of paragraph (3) with a new text. The paragraph deals with the taxation of gain attributable to the alienation of real property. Gain from the alienation of the real

property itself is dealt with in paragraph (1) of Article 7. Under paragraph (3), the Contracting State in which the underlying real property is located may tax the gain. The purpose of the change in paragraph (3) is to cover the full range of gains attributable to real property that may be taxed by the United States under the FIRPTA provisions in section 897 of the Code.

Subparagraph (a) of paragraph (3) of Article 7 provides that the United States may tax a resident of Israel on gain from the alienation of a U.S. real property interest, or from the alienation of an interest in a partnership, trust or estate, to the extent attributable to a United States real property interest. The term "U.S. real property interest" is understood to have the same meaning as the term has in section 897 of the Code. Thus, an Israeli resident would be subject to U.S. tax on gain from the alienation of shares in a U.S. corporation, the property of which consists principally of U.S.-situs real property. Similarly, an Israeli resident would be subject to tax on a liqiuidating distribution by such a U.S. corporation and on a distribution by a Real Estate Investment Trust ("REIT") attributable to gain from the alienation of U.S.-situs real property. This provision also preserves the U.S. right to tax gain from the alienation of an interest in a partnership, trust or estate, to the extent that the gain is attributable to U.S.-situs real property. Subparagraph (b) makes the provision reciprocal, and provides that Israel may tax a U.S. resident on gain from the alienation of comparable interests in Israeli real property.

ARTICLE VII

Article VII of the Protocol amends Article 12 (Dividends) of the Convention. Paragraph 1 of Article VII of the Protocol makes a technical, clarifying amendment to subparagraph (b) of paragraph (2) of Article 12. Subparagraph (b) provides for reduced rates of tax at source for intercorporate dividends under certain circumstances. The amendment clarifies that the rules in the subparagraph apply to dividends paid both by U.S. and Israeli corporations.

Paragraph 2 of Article VII of the Protocol introduces a new paragraph (3) to Article 12 of the Convention, and renumbers the previous paragraphs (3) and (4) of the Convention as paragraphs (4) and (5) respectively. The new paragraph (3) deals with dividends paid by U.S. entities that are Regulated Investment Companies ("RICs") and REITs (subparagraph (a)), and by equivalent conduit organizations in Israel (subparagraph (b)). Dividends paid by RICs are denied the 12.5 percent direct dividend rate and subjected to the 25 percent portfolio dividend rate regardless of the percentage of voting shares held directly by a corporate recipient of the dividend. A dividend paid by a REIT will be taxed in the United States at full statutory rates (30 percent), unless the beneficial

owner of the dividend is an individual resident of Israel who owns less that a 10 percent interest in the REIT, in which case he will be taxed at the portfolio dividend withholding rate of 25 percent.

The denial of the 12.5 percent withholding rate at source to all RIC and REIT shareholders, and the denial of the 25 percent rate to most shareholders of REITs is intended to prevent the use of these conduit entities to gain unjustifiable benefits for certain shareholders. For example, an Israeli corporation that wishes to hold a diversified portfolio of U.S. corporate shares may hold the portfolio directly and pay a U.S. withholding tax of 25 percent on all of the dividends that it receives. Alternatively, it may place the portfolio of U.S. stocks in a RIC, in which the Israeli corporation owns most of the shares, but in which the corporation has arranged to have a sufficient number of small shareholders to satisfy the RIC diversified ownership requirements. Since a RIC generally pays no corporate-level U.S. income tax there is no U.S. tax cost to the Israeli corporation of interposing the RIC as an intermediary in the chain of ownership. That interposition has, however, absent the special rule in paragraph (3), served to transform portfolio dividends, taxable in the United States under the Convention at 25 percent into direct investment dividends, taxable at only 12.5 percent.

Similarly, a resident of Israel may hold U.S. real property directly, and pay U.S. tax either at a 30 percent rate on the gross income or, generally, at a 31 or 35 percent on the net income. As in the preceding example, by placing the real estate holding in a REIT, the Israeli investor can transform real estate income into dividend income, and in the process, absent the special rule, transform, at no tax cost, high-taxed income into lower-taxed income. In the absence of the special rule, if the REIT shareholder is an Israeli corporation that owns at least a 10 percent interest in the REIT, the withholding rate would be 12.5 percent; in all other cases it would be 25 percent. In either event, with one exception, a tax of at least 30 percent would be significantly reduced. The exception is the relatively small individual Israeli investor who might be subject to a U.S. tax of 15 percent of the net income even if he earned the real estate income directly. Under the rule in subparagraph (a), such individuals, defined as those holding less than a 10-percent interest in the REIT, remain taxable at source at a 25-percent portfolio dividends withholding rate.

Subparagraph (b) of paragraph (3) provides analogous rules for dividends paid by certain Israeli corporations. Under that new subparagraph, the reduced rates of tax at source on dividends provided in paragraph (2) do not apply to dividends paid by certain Israeli corporations that are taxed in a "pass-through" manner. The income of these corporations is taxed in the manner described in Sections 64 and 64A of the Israeli Income Tax Ordinance. Paragraph 9 of the Exchange of Notes explains that there are

several types of "pass-through" corporations that meet the standard of subparagraph (b). The corporation may be exempt from tax; the shareholders may be subject to tax on their pro-rata shares of the corporation's income; or the corporation may deduct its dividends paid from its taxable income. In cases covered by this subparagraph, the income is treated as if it were business profits from a permanent establishment, taxable according to the rules of Article 8 (Business Profits).

ARTICLE VIII

Article VIII of the Protocol amends Article 13 (Interest) of the Convention. Paragraph 1 of Article VIII adds a new subparagraph (b) to paragraph (2) of Article 13, designating paragraph (2), as it appeared in the Convention, as subparagraph (a) of paragraph (2). Subparagraph (b) provides an alternative rule for the taxation of interest at source. Subparagraph (a) provides for withholding at source at either a 17.5 or 10 percent rate, the latter applying to interest on loans made by financial institutions. The gross-basis withholding tax of subparagraph (a) will not apply if, under subparagraph (b), the interest recipient elects to be taxed by the source State on its net interest income, under the rules of Article 8 (Business Profits), as though the interest income were industrial and commercial profits, attributable to a permanent establishment in the source State. The paragraph further provides for the adoption by each competent authority of rules for determining and reporting taxable income under this provision. Each competent authority also may adopt procedures requiring the provision by the taxpayer of adequate books and records for determining the proper amount of net income. The U.S. competent authority will provide rules for the apportionment of expenses, as would be required under Article 8, in determining net income for purposes of U.S. source basis tax.

Paragraph 2 of Article VIII of the Protocol adds a new paragraph (8) to Article 13 (Interest). Paragraph (8) provides that the reductions in tax at source for interest provided for in paragraph (2), and the exemption at source provided for in paragraph (3), do not apply to an excess inclusion with respect to a residual interest in a U.S. real estate mortgage investment conduit (REMIC). This class of income, therefore, will remain subject to the statutory 30-percent U.S. rate of tax at source under paragraph 1. This provision is consistent with the policy of sections 860E(e) and 860G(b) that excess inclusions with respect to a real estate mortgage investment conduit (REMIC) should bear full U.S. tax in all cases. Without a full tax at source foreign purchasers of residual interests would have a competitive advantage over U.S. purchasers when these interests are initially offered for sale. Also, absent this rule the U.S. fisc would suffer a revenue loss with respect to mortgages held in a REMIC because of opportu-

nities for tax avoidance created by differences in the timing of taxable and economic income produced by these interests.

Paragraph 10 of the Exchange of Notes relates to paragraph (8) of Article 13 (Interest). It reflects the understanding that paragraph (8) was added at the request of the United States to address a problem of domestic tax avoidance arising under U.S. internal law, and notes that the United States intends to include similar provisions in all of its future treaties. The Exchange of Notes also acknowledges that the United States possibly could revise its internal laws in the future to address this problem in a manner other than by imposing tax on the recipient of the excess inclusion so that an excess inclusion under the revised laws would be treated as ordinary interest income in the hands of nonresident recipients and would be eligible for the exemptions from tax applicable to interest income under the laws of the United States. In that case such exemption would, notwithstanding paragraph (8), apply to an Israeli recipient of an excess inclusion. It is further noted that if the United States fails to include a provision similar to paragraph (8) of Article 13 in any tax treaty signed subsequent to the entry into force of this Convention, without having revised its internal laws in the manner suggested in the preceding sentence, such a change in U.S. treaty policy would make it appropriate to amend the Convention on this matter, pursuant to paragraph (8) of Article 6 of the Convention.

ARTICLE IX

Article IX of the Protocol adds a new Article 14A (Branch Tax) to the Convention. Article 14A provides for the imposition by the United States of a branch tax, both on the "dividend equivalent amount" and on "excess interest", and the imposition by Israel of a comparable tax should Israeli law be amended in the future to impose such a tax. Paragraph (1) of Article 14 confirms the right of each of the Contracting States to impose on a resident of the other, a tax in addition to the tax allowable under the other provisions of the Convention.

The bases of the U.S. taxes are described in subparagraph (a) of paragraph 2. The "dividend equivalent amount" is described in sub-subparagraph (i) and the excess interest that is subject to U.S. tax is described in sub-subparagraph (ii). The Convention does not define the term "dividend equivalent amount". It is, therefore, understood to have the same meaning as in section 884(b) of the Code and the regulations thereunder. Generally the dividend equivalent amount is the earnings and profits of the foreign corporation (i.e, the profits of the corporation after certain adjustments including a reduction for U.S. corporate income tax) that are effectively connected with the conduct of its trade or business in the United States, decreased by any increase during the taxable year in the corporation's U.S. assets less liabilities

("U.S. net equity") or increased by any decrease in its U.S. net equity. Under the Convention the dividend equivalent amount is subject to U.S. tax only to the extent it is attributable to a U.S. permanent establishment.

Under the Convention, the dividend equivalent amount for any year approximates the dividend that a U.S. branch office would have paid its home office during the year if the branch had been operated as a separate U.S. subsidiary company. The dividend equivalent amount is determined taking into account not only effectively connected earnings and profits (or profits that are deemed to be effectively connected) that are attributable to a permanent establishment in the United States but also most profits from the disposition or operation of real estate that are subject to net basis income taxation in the United States under Article 7 (Income From Real Property)) or Article 15 (Capital Gains). Thus, the United States may impose its branch profits tax on the earnings and profits of an Israeli corporation attributable to a permanent establishment in the United States and on the earnings and profits that, in accordance with the Convention, are subject to taxation under U.S. internal law on a net basis either because the Israeli corporation has elected under Code section 882(d) to treat income from real property not otherwise taxed on a net basis as effectively connected income or because the income is gain that is taxable on a net basis, e.g, because it is attributable to the disposition of a United States Real Property Interest (other than an interest in a United States Real Property Holding Corporation).

Subparagraph (ii) of subparagraph (a) provides for the imposition of the U.S. tax on excess interest. Under section 884(f)(1)-(B) of the Code, excess interest is the excess of the total amount allowable as a deduction in computing the U.S. effectively connected income of a foreign corporation over the total interest paid by the foreign corporation's U.S. trade or business. Under the Convention, the tax on excess interest applies only to the excess of interest that is deductible in computing (i) the U.S. tax on income attributable to a permanent establishment of an Israeli corporation in the United States and (ii) the U.S. tax on income or gain from real property (although not including, under current U.S. law, gain on shares in a United States Real Property Holding Corporation) over the interest paid by the foreign corporation's U.S. permanent establishment.

Israel does not impose a comparable tax on a dividend equivalent amount or on excess interest under current law. Subparagraph (b) of paragraph (2), however, permits Israel to impose a tax comparable to the U.S. tax described in paragraph (a) should Israeli law, in the future, be amended to provide such a tax. The permitted Israeli tax could be imposed on an Israeli branch of a U.S. corporation such that the branch would be taxed in a manner comparable to a similarly situated Israeli subsidiary and its U.S. parent corporation. The language of the Article permits

the tax to be imposed on an Israeli branch, rather than a permanent establishment, because Israel was reluctant to limit its future flexibility in designing a tax. However, as explained in paragraph 11 of the Exchange of Notes, Israel has agreed that, if Israel should, at some time in the future, impose a tax under subparagraph (b) of this Article in circumstances where the United States would not impose a tax under subparagraph (a), the competent authorities will consult with a view to conforming the two countries' rules under the Convention. Paragraph 11 of the Exchange of Notes states a further understanding that if a resident of a Contracting State qualifies for benefits under the Convention (i.e., the resident satisfies one or more of the tests of Article 25 (Limitation on Benefits)) that person will not be subject to the branch tax imposed by the other Contracting State, except as provided in the Convention. This merely confirms to Israel the result under U.S. law that the "qualified residence" rules of Code section 884(e)(4) do not override the Limitation on Benefits rules of the Convention to deny branch tax benefits to a resident of Israel in circumstances where Convention's benefits would have been allowed under Article 25.

Paragraph (3) specifies the rates at which the taxes described in paragraph (2) may be imposed. Under subparagraph (a), the rate applicable in the United States to the tax on dividend equivalent amount may not exceed 12.5 percent. This is the general rate provided for in paragraph (2) of Article 12 (Dividends) applicable to direct investment dividends. Under subparagraph (b), the maximum rate of U.S. tax on excess interest is 5 percent. The rate should approximate the rate at which interest derived by a resident of Israel from U.S. sources is taxed by the United States. The 5 percent rate in subparagraph (b) represents a "blended rate", reflecting the fact that under Article 13 (Interest) subject to source country tax at a variety of rates varying from zero to 17.5 percent on gross interest, or at regular graduated rates on interest less expenses. Subparagraph (c) provides that, in the event that Israel imposes a tax of the type dealt with in Article 14A, the rate will not exceed the rate applicable in the United States under subparagraphs (a) and (b) on analogous classes of income.

ARTICLE X

Article X of the Protocol makes two amendments to Article 15 (Capital Gains) of the Convention, which provides that gain derived by a resident of a Contracting State from the sale, exchange or other disposition of a capital asset shall be exempt from tax in the other Contracting State, except in certain enumerated cases.

Paragraph 1 of Article X of the Protocol amends subparagraph (a) of paragraph (1) of Article 15 of the Convention which cross refers to Article 7 (Income from Real Property) in order to better

describe the rights of the situs state to tax gain attributable to real property under that Article. The amendment is necessary in light of the clarifying changes to Article 7 made by Article VI of the Protocol.

Paragraph 2 of Article X of the Protocol amends subparagraph (e) of paragraph (1) of Article 15 of the Convention in order to modify the cases in which Israel may tax gain derived by a U.S. resident from the sale, exchange or other disposition of shares in an Israeli corporation. Although the subparagraph is worded reciprocally, it does not provide any additional taxing rights to the United States. Under the Code the only gain (other than gain that is effectively connected with a U.S. trade or business) from the disposition of shares in a U.S. corporation by a nonresident alien or foreign corporation that the United States taxes is gain from the disposition of shares in a United States Real Property Holding Corporation, and that taxing right is granted by Article 7 of the Convention.

Under subparagraph (e) of paragraph (1) of Article 15 of the Convention as amended by the Protocol, Israel may tax a U.S. resident on gain from the disposition of shares in an Israeli corporation provided the U.S. resident owned, either directly or indirectly, at any time during the 12-month period prior to the sale, shares possessing at least 10 percent of the voting power of the corporation. This gain is treated as foreign source income for purposes of determining the limitation on the U.S. foreign tax credit under Article 4 (Source of Income) as amended by Article II of the Protocol and Article 26 (Relief From Double taxation) as amended by Article XIII of the Protocol. Prior to amendment by the Protocol, the required ownership threshold was higher (more than 50 percent of the corporation's voting power during the 12-month period prior to the sale) and there also was a requirement that a substantial portion of the corporation's assets was used to carry on business in Israel for the three taxable years prior to the disposition.

Paragraph 3 of Article X of the Protocol adds a new paragraph (2) to Article 15 which limits the gain that Israel may tax under subparagraph (e) of paragraph (1) to the amount of boot received in an otherwise tax-free reorganization of a U.S. affiliated group. In order for the provision to apply three conditions must be satisfied. First, the transferor and the transferee must be resident in the same Contracting State (the United States). Second, the transferor and the transferee must own directly or indirectly 80 percent or more of the voting rights and value of the other, or a company resident in the same Contracting State as the transferor and the transferee must own directly, or indirectly through companies resident in the same Contracting State, 80 percent or more of the vote and value of the transferor and transferee. (This condition would be satisfied by a U.S. affiliated group). Finally, the transferee's basis, for purposes of determining gain or loss in

the State in which it is resident, must be determined, in whole or in part, by reference to the transferor's basis (i.e, the transaction must be a tax-free reorganization under section 368 of the Code so that the transferee's basis is determined under section 362(b) of the Code).

If these three conditions are satisfied then the gain that Israel may tax under subparagraph (e) is limited to the amount of cash or other property received by the transferor, which is the same as the amount of gain that would be recognized under section 356(a) of the Code and taxed by the United States. In the event a larger amount of gain may be taxed in the transferor's State of residence, then the other Contracting State may tax the gain in accordance with its domestic law (applied consistently with the Convention). However, if the carryover-basis rule of section 362(b) of the Code applies to a transaction then the limitation of section 356(a) of the Code must also apply, so that this is not a possibility under U.S. law at this time.

ARTICLE XI

Article XI of the Protocol amends Article 22 (Governmental Functions) of the Convention. The Protocol adds two new paragraphs to the Article that expand the scope of "public funds of a Contracting State" and "employment by a Contracting State" to cover more than the Contracting States themselves. Paragraphs (2) and (3) expand these terms to mean public funds of, and employment by, (i) a Contracting State or a political subdivision or local authority thereof; (ii) a corporation that is wholly owned by a Contracting State or a political subdivision or local authority thereof, provided the corporation performs functions of a governmental nature; and (iii) a body that is treated for tax purposes the same as a Contracting State or a political subdivision or local authority thereof and that performs functions of a Governmental nature.

ARTICLE XII

Article XII of the Protocol replaces Article 25 (Investment or Holding Companies) of the Convention with a new Article 25 (Limitation on Benefits). Article 25 ensures that source-basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State that have a substantial nexus with that State. For example, a resident of a third State might establish an entity resident in a Contracting State for the purpose of deriving income from the other Contracting State and claiming source-State benefits with respect to that income. Absent Article 25, the entity would generally be entitled to benefits as a resident of a Contracting State, subject, to any limitations imposed by the domestic law of

the source State, (e.g., business purpose, substance-over-form, step transaction or conduit principles).

Paragraph 1 describes two conditions either of which if satisfied will disqualify a person from claiming benefits under the Convention, unless the person qualifies for benefits under either paragraphs (3) or (4). Paragraph (2) contains a special rule aimed at companies that issue "alphabet" stock to third country residents in order to allow them to effectively claim benefits under the Convention. Although the structure of this Article differs from the limitation on benefits articles of other recent treaties (e.g., the Convention Between the Federal Republic of Germany and the United States of America) it achieves the same result.

Under paragraph (1), benefits will be denied to a resident of a Contracting State, such as a corporation, partnership or trust, if either (i) 50 percent or more of the beneficial interests in the person (or, in the case of a corporation, 50 percent or more of the voting power or value of its shares) is owned, directly or indirectly, by individuals who are not residents of a Contracting State, and who are not citizens of a Contracting State who are subject to tax in that State on worldwide income, or (ii) 50 percent or more of the person's gross income is used in substantial part, directly or indirectly, to meet liabilities in the form of deductible payments (including liabilities for interest or royalties) to persons who are residents of a state other than a Contracting State, and who are not citizens of a Contracting State who are subject to tax in that State on worldwide income.

The rationale for disqualifying a resident of a Contracting State in these two cases is that treaty benefits can be indirectly enjoyed not only by equity holders of an entity, but also by that entity's various classes of obligees, such as lenders, licensors, service providers, insurers and reinsurers, and others. Accordingly, it is not enough, in order to prevent such benefits from inuring substantially to third-country residents, merely to require substantial ownership of the entity by treaty country residents. It also is necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or their equivalents.

Paragraph (2) address the potential for abuse when a company (or another company that controls that company) issues a class of shares that entitles its holders to a disproportionately high share of income derived in the other Contracting State, either from activities performed or assets located in that State. If 50 percent or more of the shares of this class is owned, directly or indirectly, by persons that would disqualify the corporation for benefits under subparagraph (a) of paragraph (1), then the Convention's benefits with respect income attributable to those assets or activities will be denied by paragraph (2). For example, a U.S. holding company could issue a class of shares (class B shares)

entitling the class B shareholders to the dividends received from an Israeli subsidiary operating in Israel. If more than 50 percent of the vote and value of all of the U.S. company's shares is held by U.S. residents the holding company would not be denied benefits under paragraph (1). However, if a majority of the class B shares were held by third-country residents, paragraph (2) would deny the benefits of the Convention (reduced Israeli tax at source) with respect to the Israeli subsidiary's dividends. Were this not the rule and assuming there were a treaty in effect between the United States and the third country to reduce the U.S. dividend withholding tax, this structure would provide opportunities for third country residents to effectively claim the benefits of the Convention on dividends paid by the Israeli corporation.

Paragraph (3) identifies a number of classes of persons resident in one Contracting State that are entitled to treaty benefits from the other, either in full or with respect to particular items of income, notwithstanding paragraphs (1) and (2). First, under subparagraph (a), individuals who are residents of a Contracting State are, without qualification, entitled to benefits under the Convention. Second, subparagraph (b) provides that (i) a Contracting State or a political subdivision or local authority thereof, (ii) a corporation that is wholly owned by a Contracting State or a political subdivision or local authority thereof, provided the corporation performs functions of a Governmental nature, and (iii) a body that is treated for tax purposes the same as a Contracting State or a political subdivision or local authority thereof and that performs functions of a Governmental nature, are entitled to benefits under the Convention.

Subparagraph (c) of paragraph (3) provides a test for eligibility for benefits that looks not solely at objective characteristics of the person deriving the income, but at the nature of the activity carried on by that person and the connection between the income and that activity. Under subparagraph (c) a resident of a Contracting State deriving income from the other Contracting State is entitled to benefits if the recipient is engaged in an active trade or business in its State of residence, and the item of income in question is derived in connection with, or is incidental to, that trade or business. For this purpose an active trade or business does not include the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. This relationship test is applied separately for each item of income, and it is intended that the provisions of this paragraph are self-executing. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the subparagraph and is not entitled to the benefits claimed.

The first six examples in the Memorandum of Understanding Regarding the Scope of the Limitations on Benefits Article in the Convention Between the Federal Republic of Germany and the United

States of America illustrate the situations intended to be covered by this provision. For example, income is considered "derived in connection with" an active trade or business when the income is a dividend paid to a United States manufacturing company by its sales subsidiary in Israel that is selling in Israel the output of the U.S. parent. Income would be considered "incidental to" an active trade or business if, for example, the income were dividends earned by an Israeli corporation from investing some of its working capital, temporarily, in U.S. preferred shares. Even if the Israeli company has no other activities in the United States, the dividends from those shares would be considered incidental to the active business of the company in Israel, and would be entitled to U.S. treaty benefits.

Under subparagraph (d) of paragraph (3), a corporation that is a resident of a Contracting State is entitled to treaty benefits from the other Contracting State if there is substantial and regular trading in the corporation's principal class of shares on a recognized stock exchange. The term "recognized stock exchange" is defined in paragraph (5) of the Article to mean, in the United States, the NASDAQ System and any stock exchange that is registered as a national securities exchange with the Securities and Exchange Commission for purposes of the Securities Exchange Act of 1934. In Israel, the term means the Tel Aviv Stock Exchange, and any other Israeli stock exchange that may be approved by the Israeli Minister of Finance. The competent authorities may, by mutual agreement, recognize additional exchanges for purposes of subparagraph (d).

Subparagraph (e) of paragraph (3) provides that a not-for-profit organization that is a resident of a Contracting State is entitled to benefits from the other Contracting State if it satisfies two conditions: (i) it generally must be exempt from tax in its State of residence by virtue of its not-for-profit status; and (ii) more than half of the beneficiaries, members or participants, if any, in the organization must be persons entitled, under this Article, to the benefits of the Convention. The not-for-profit organizations dealt with in the subparagraph include pension funds, pension trusts, private foundations, trade unions, trade associations and similar organizations. Thus, an Israeli pension fund that provides pension benefits principally to Israeli residents would be entitled to benefits with respect to its U.S. source investment income.

Paragraph (4) provides that a resident of a Contracting State that derives income from the other Contracting State and is not entitled to the benefits of the Convention under other provisions of the Article may, nevertheless, be granted benefits at the discretion of the competent authority of the Contracting State in which the income arises. The paragraph further provides that if a competent authority proposes to deny a request for benefits under this provision, either competent authority may request consultations with the other to discuss the issue.

The paragraph itself provides no guidance to competent authorities or taxpayers as to how the discretionary authority is to be exercised. It is understood, however, that in making determinations under paragraph (4), the competent authorities will take into account all relevant facts and circumstances. The factual criteria that the competent authorities are expected to take into account include the existence of a clear business purpose for the structure and location of the income earning entity in question; the conduct of an active trade or business (as opposed to a mere investment activity) by such entity; and a valid business nexus between that entity and the activity giving rise to the income. Paragraph 13 of the Exchange of Notes, for example, states the understanding that benefits would be likely to be granted by the competent authority in the case of a resident of a Contracting State that did not pass the base-erosion test of paragraph (1) of the Article because of large interest payments on a bona-fide loan from a financial institution resident in a third country. For this purpose a "bona-fide loan" would not include a conduit financing arrangement recharacterized under section 7701(l) of the Code or Rev. Rul. 87-89, 1987-2 C.B. 195.

For purposes of implementing paragraph (4), a taxpayer will be permitted to present his case to his competent authority for an advance determination based on the facts, and will not be required to wait until the tax authorities of one of the Contracting States have determined that benefits are denied under one of the other provisions of the Article. It also is expected that if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

Subparagraph (c) of paragraph (4) provides that the competent authorities are expected to consult with a view to developing agreed procedures for the application of Article 25, including, as provided in paragraph 14 of the Exchange of Notes, the development of a Memorandum of Understanding to provide guidance to both taxpayers and tax administrations. It is further expected that as, over time, the tax authorities of the Contracting States gain experience in administering the provisions of Article 25, further guidance will be developed and published.

ARTICLE XIII

Article XIII of the Protocol amends Article 26 (Relief from Double Taxation) of the Convention. Paragraph (1) of Article XIII replaces paragraph (2) of Article 26. Due to changes in law, paragraph (2) of the Convention dealing with payments made or received on a compulsory loan to Israel is no longer relevant. The new paragraph (2) provides special rules for the tax treatment in both Contracting States of certain types of income derived from

U.S. sources by U.S. citizens who are resident in Israel. Since U.S. citizens are subject to United States tax at graduated rates on their worldwide income, the U.S. tax on the U.S. source income of a U.S. citizen resident in Israel will often exceed the U.S. tax allowable under the Convention on an item of U.S. source income derived by a resident of Israel who is not a U.S. citizen. Without this provision U.S. citizens resident in Israel would potentially be subject to double taxation with respect to this income.

Subparagraph (a) of paragraph (2) provides a special Israeli credit rule with respect to items of income that are either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the Convention when received by Israeli residents who are not U.S. citizens. The Israeli foreign tax credit allowed by subparagraph (a) under these circumstances, to the extent consistent with Israeli law, need not exceed the U.S. tax that may be imposed under the provisions of the Convention, other than tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Thus, if a U.S. citizen resident in Israel receives U.S. source dividends, the Israeli foreign tax credit would be limited to 25 percent of the dividend -- the U.S. tax that may be imposed under subparagraph (a) paragraph (2) of Article 12 (Dividends) -- even if the shareholder is subject to a U.S. rate of tax of 31 percent (or more) because of his U.S. citizenship.

Subparagraph (b) of paragraph (2) deals with the potential for double taxation that can arise as a result of the absence of a full Israeli foreign tax credit for the U.S. tax imposed on its citizens resident in Israel. The subparagraph provides that the United States will credit the Israeli income tax paid, after the Israeli credit provided for in subparagraph (a). It further provides that in allowing the credit, the United States will not reduce its tax below the amount that is allowed as a creditable tax in Israel under subparagraph (a) (i.e., the amount that the United States may impose on an Israeli resident under the Convention). Since the income that is dealt with in this paragraph is U.S. source income, special rules are required to resource some of the income as Israeli source in order for the United States to be able to credit the Israeli tax. This resourcing rule is provided for in subparagraph (c), which deems the items of income referred to in subparagraph (a) of paragraph (2) to be from Israeli sources to the extent, but only to the extent, necessary to avoid double taxation under subparagraph (b). Thus, no excess credits can be generated in applying this rule that can be used against U.S. tax on any other item of income.

Paragraph 2 of Article XIII of the Protocol makes a clarifying amendment to the Israeli foreign tax credit rule in paragraph (3) of Article 26. As amended, the paragraph makes clear that the Israeli foreign tax credit is applied in a manner consistent with

the provisions and limitations of Israeli law concerning the provision of a foreign tax credit, as the law is in force at the time the provision is being applied. However, the law as it is applied at any time must be consistent with the general provisions of the paragraph, i.e., it must continue to provide for a full foreign tax credit for U.S. income tax.

Paragraph 3 of Article XIII of the Protocol adds a new paragraph (4) to Article 26 of the Convention. Paragraph (4) specifies how the source rules in Article 4 (Source of Income) are to apply for purposes of computing the foreign tax credit under Article 26. It provides, first, that the source rule for the taxation of gain on tangible or intangible assets in paragraph (6) of Article 4 (Source of Income) applies for the purpose of computing the foreign tax credit under Article 26. It is intended that this rule apply notwithstanding the saving clause of paragraph (3) of Article 6. Thus, where subparagraph (e) of paragraph (1) of Article 15 (Capital Gains) gives one Contracting State the right to tax the gain of a resident of the other on the alienation of shares in a corporation of the first-mentioned State, the gain will be sourced, for credit purposes, in that first-mentioned State. Paragraph (4) provides further that the other source rules in Article 4 also will apply for foreign tax credit purposes, to the extent not prohibited by the domestic law of the Contracting State that is providing the credit. Thus, in computing the U.S. foreign tax credit section 904(g) of the Code, which provides for particular source rules for foreign tax credit purposes, will apply. Moreover, other source rules in Article 4 also would yield to conflicting source rules of domestic law without regard to their date of enactment.

Article XVII of the Protocol, providing the rules for entry into force and effective dates for the Second Protocol, contains a rule that refers to Article 26. Article XVII of the Protocol provides that when the Second Protocol (and, by inference, the Convention as amended by the second Protocol) enters into force, the penultimate sentence of paragraph (1) of Article 26 is to be read as if that sentence had entered into force on May 30, 1980. This is intended to ensure that any U.S. statutory enactment of source rules for foreign tax credit purposes after May 30, 1980, that were intended by the Congress to apply notwithstanding any pre-existing treaty rule to the contrary, would apply under this Convention.

The rules of paragraph (4) of Article 26 and of the penultimate sentence of paragraph (1) of Article 26 generally have the same effect. However, it is not intended that the penultimate sentence of paragraph (1) of Article 26 in any way limit or otherwise affect the source rules as determined under paragraph (4) of Article 26.

Finally, paragraph 15 of the Exchange of Notes clarifies that the meaning of the terms "stock or intangible" in paragraph (4) has the meaning ascribed to it in section 865(h) of the Code when the taxpayer elects under that section.

ARTICLE XIV

Article XIV of the Protocol amends Article 27 (Non-discrimination) of the Convention. Paragraph (1) of Article XIV replaces paragraph (1) of Article 27 of the Convention with a new paragraph (1). The new paragraph conforms more closely to the corresponding paragraph in the 1981 U.S. Model. Paragraph 1, as amended, provides that a citizen of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State that are different from, or more burdensome than, the taxes and connected requirements imposed upon a citizen of that other State in the same circumstances. A citizen of a Contracting State is afforded protection under this paragraph even if he is not a resident of either Contracting State. The paragraph also provides that the United States need not apply the same taxing regime to an Israeli citizen who is not resident in the United States that it applies to a U.S. citizen who is not resident in the United States because these persons are not in the same circumstances. A U.S. citizen who is not a resident of the United States is subject to United States tax on his worldwide income, unlike a citizen of Israel who is not U.S. resident. Thus, Article 27 would not entitle an Israeli citizen not resident in the United States to the net basis taxation of U.S. source dividends or other investment income, which applies to a U.S. citizen not resident in the United States. A U.S. citizen who is resident in a third country, however, is entitled, under this paragraph, to the same treatment in Israel as an Israeli citizen who is in similar circumstances.

Paragraph 2 of Article XIV of the Protocol adds a new paragraph (4) to Article 27 (Nondiscrimination). Paragraph (4) specifies that no provision of the Article will prevent either Contracting State from imposing the branch tax described in Article 14A (Branch Tax). Thus, even if the branch tax were judged to violate the provisions of the other paragraphs of the Article, neither Contracting State would be constrained from imposing the tax.

During the course of the negotiation of the Second Protocol, understandings were reached regarding the application of Article 27 to two aspects of U.S. tax law. Section 1446 of the Code imposes on any partnership with income that is effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the Convention, this obligation applies with respect to an Israeli resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with

respect to the distributive share of a U.S. resident partner. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraph (2) of the Article. No distinction is made between U.S. and Israeli partnerships, since the law requires that partnerships of both States withhold tax in respect of the distributive shares of non-U.S. partners. In distinguishing between U.S. and Israeli partners, the requirement to withhold on the Israeli but not the U.S. partner's share is not discriminatory taxation, but, like other withholding on nonresident aliens, is merely a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it may otherwise be difficult for the United States to enforce its tax jurisdiction. If tax has been overwithheld, the partner can, as in other cases of overwithholding, file for a refund. For the same reasons, it also is understood that these provisions in section 1446 do not violate paragraph (3) of the Article.

The TRA introduced section 367(e)(2) of the Code, which changed the rules for taxing corporations on certain distributions they make in liquidation. Prior to the TRA, corporations were not taxed on distributions of appreciated property in complete liquidation, although non-liquidating distributions of the same property, with several exceptions, resulted in corporate-level tax. In part to eliminate this disparity, the law now generally taxes corporations on the liquidating distribution of appreciated property. The Code provides an exception in the case of distributions by 80 percent or more controlled subsidiaries to their parent corporations, because the assets' built-in gain will be recognized when the parent sells or distributes the asset. This exception does not apply to distributions to parent corporations that are tax-exempt organizations or, except to the extent provided in regulations, foreign corporations. The policy of the legislation is to collect one corporate-level tax on the liquidating distribution of appreciated property; if and only if that tax can be collected on a subsequent sale or distribution does the legislation defer the tax. It is understood that the inapplicability of the exception to the tax on distributions to foreign parent corporations does not conflict with paragraph (3) of the Article. While a liquidating distribution to a U.S. parent will not be taxed, and, except to the extent provided in regulations, a liquidating distribution to a foreign parent will, paragraph (3) merely prohibits discrimination among corporate taxpayers on the basis of U.S. or foreign stock ownership. Eligibility for the exception to the tax on liquidating distributions for distributions to non-exempt, U.S. corporate parents is not based upon the nationality of the owners of the distributing corporation, but rather is based upon whether such owners would be subject to corporate tax if they subsequently sold or distributed the same property. Thus, the exception does not apply to distributions to persons that would not be so subject -- not only foreign corporations, but also tax-exempt organizations.

ARTICLE XV

Article XV of the Protocol amends Article 29 (Exchange of Information) of the Convention, by replacing paragraph (1) of Article 29 with a new paragraph. As amended, paragraph (1) provides for the exchange of information between the competent authorities of the Contracting States. The information to be exchanged is that pertinent for carrying out the provisions of the Convention or the prevention of fraud or evasion in relation to U.S. or Israeli taxes that are covered by the Convention. Thus, for example, information may be exchanged with respect to a covered tax, even if the transaction to which the information relates is a purely domestic transaction in the requesting State and, therefore, the exchange is not made for the purpose of carrying out the Convention. The exchange must, however, be for the purpose of preventing fraud or evasion with respect to that tax.

Paragraph (1) also provides assurances that any information exchanged will be treated as secret. Information received may be disclosed only to persons or authorities concerned with the assessment (including judicial determination), collection, or administration of the taxes to which the Article relates. The information must be used by these persons in connection with these designated functions. Persons concerned with the administration of taxes, in the United States, include legislative bodies, such as the tax-writing committees of Congress and the General Accounting Office. Otherwise confidential information may be received by these bodies but only for their use in the performance of their role in overseeing the administration of U.S. tax laws.

ARTICLE XVI

Article XVI of the Protocol amends Article 31 (Entry Into Force) of the Convention, by replacing the rule in subparagraph (b) of Article 31 providing the effective date for taxes other than withholding taxes (which is provided for under subparagraph (a)). Subparagraph (b), as amended, provides alternative effective date rules, depending on the time of the year that the Convention enters into force, according to the provisions of the introductory language of Article 31. If the Convention enters into force prior to July 1 of any calendar year, the Convention will have effect, for taxes other than withholding taxes, for taxable years beginning on or after January 1 of the year in which the Convention enters into force. If, however, the Convention enters into force after June 30 of any calendar year, it will have effect, for taxes other than withholding taxes, for taxable years beginning on or after January 1 of the year following entry into force of the Convention.

ARTICLE XVII

Article XVII provides the rules for the entry into force of the second Protocol. The Protocol is subject to ratification by both Contracting States. It will enter into force 30 days after the exchange of instruments of ratification, and its provisions will take effect in accordance with the provisions of Article 31 (Entry Into Force) of the Convention.

A special rule in Article XVIII relating to the applicable source rules for U.S. foreign tax credit purposes is described in the explanation of Article 26 (Relief from Double Taxation).

EXCHANGE OF NOTES

Two paragraphs in the Exchange of Notes were not described above in connection with Articles of the Protocol.

Paragraph 8 relates to Article 10 (Grants) of the Convention. It clarifies that the failure by Israel to include a grant in the basis of stock or assets for income tax purposes is understood not to mean that the grant is "taxed by Israel".

Paragraph 16 makes clear that a reference in the Convention to the currency of one of the Contracting States is to be understood to be a reference to the currency as it is named at the time the relevant rule of the Convention is being applied. Thus, the references in Articles 18 (Public Entertainers) and 24 (Students and Trainees) to Israeli pounds, are understood today to be a reference to Israeli shekels.

**UNITED STATES TREASURY DEPARTMENT TECHNICAL EXPLANATION
OF THE PROTOCOL TO THE CONVENTION
BETWEEN BARBADOS AND THE UNITED STATES OF AMERICA
FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF
FISCAL EVASION WITH RESPECT TO TAXES ON INCOME
SIGNED ON DECEMBER 31, 1984**

The Protocol, signed at Washington, D.C. on December 18, 1991, ("the Protocol") amends the Convention between Barbados and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on December 31, 1984 ("the Convention").

The technical explanation is an official guide to the Protocol. It reflects policies behind particular provisions, as well as understandings reached with respect to the interpretation and application of the Protocol. The technical explanation does not provide a complete comparison between the Protocol and the Articles of the Convention that it amends. Unless specified to the contrary, references to the OECD Model are to the 1992 Model Tax Convention on Income and Capital of the OECD, and references to the U.S. Model are to the U.S. Treasury Department's 1981 Draft Model Income Tax Convention. Although the 1981 Model has been withdrawn, and a new Model is being developed as this Technical Explanation is being drafted, the 1981 Model was the relevant Model at the time the Protocol was negotiated.

Article I

Article I of the Protocol amends Article 5 (Permanent Establishment) of the Convention. As amended, Article 5 conforms in all but one respect to Article 5 of the U.S. Model and, in general, to that Article as it appears in the OECD Model. The general effect of the amendments is to raise the thresholds for the taxation under Article 7 (Business Profits) by one country of the business profits of an enterprise of the other, thus limiting the circumstances in which business profits may be taxed. The amendments to Article 5 are also relevant to the application of Article 14 (Independent Personal Services). The term "regular base" in that Article (which is equivalent to the term "fixed base" in Article 14 of the U.S. and OECD Models) is to be understood by reference to the definition of the term "permanent establishment" in Article 5.

Paragraph 1 defines the term "permanent establishment" as a fixed place of business through which the business of an enterprise is partly or wholly carried on. Paragraph 2 elaborates on this definition by providing an illustrative, non-exclusive, list of fixed places of business. The list in paragraph 2 differs from that in the Convention in that the phrase "a store or premises used

as a sales outlet" is deleted. That deletion conforms the language of the paragraph to that of the U.S. Model, but does not change its application or scope, because a store or premises used as a sales outlet would, in any event, be a "fixed place of business through which the business of an enterprise is wholly or partly carried on." Paragraph 2 in the Protocol does not include the special threshold tests dealing with dredging projects, the furnishing of services and the maintenance of substantial equipment or machinery that are found in the Convention. Under the Article as revised by the Protocol, these activities will be subject to the normal tests of the Article, and, therefore, to a higher threshold.

Paragraph 3 provides, as does the comparable paragraph in the Convention, that a building site, a construction or installation project or a drilling rig or ship used for the exploration or exploitation of natural resources constitutes a permanent establishment only if it lasts for more than 183 days in any 12-month period. This is the one respect in which Article 5, as amended, differs from the corresponding Article in the U.S. Model. In the Model, such a site, project, rig or ship constitutes a permanent establishment only if it lasts for more than 12 months. As under the Convention, the 183-day period begins when any work (including preparatory work carried on by the enterprise) physically begins in a Contracting State. As under the Convention, the 183-day test in paragraph 3 applies separately to each individual site, project or rig. However, a series of contracts or projects that are interdependent both commercially and geographically are to be treated as a single project for purposes of applying the 183-day threshold test. If the 183-day threshold is exceeded, the site, project or rig constitutes a permanent establishment from its first day.

The rule in the Convention specified that the 183-day period includes "the period of any supervisory activity connected therewith". As amended by the Protocol, the Article does not contain this language. This deletion does not change the meaning of the rule. This conclusion is supported by the Commentary to Article 5 of the OECD Model which states, with respect to supervisory activities in connection with a construction site, that planning and supervision of a building construction project are included within the rule of paragraph 3 if the activities are carried out by the building contractor. The Commentaries to the OECD Model are also useful in interpreting other provisions of the permanent establishment article in the Protocol, where the language of those provisions is the same as that of the OECD Model.

Paragraph 4 of Article 5 as amended by the Protocol replaces paragraph 3 of the Article in the Convention. While there are some differences in language between the two versions of the paragraph, they are alike in substance. The paragraph provides exceptions to the general rule of paragraph 1 that a fixed place of business through which a business is carried on constitutes a permanent establishment. The paragraph lists a number of activities that may

be carried on through a fixed place of business, but which, nevertheless, will not give rise to a permanent establishment. The use of facilities solely to store, deliver or display merchandise belonging to the enterprise will not constitute a permanent establishment of that enterprise, nor will the maintenance of a stock of goods belonging to the enterprise solely for the purpose of storage, display or delivery, or solely for processing by another enterprise. The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or for acquiring information for the enterprise, or solely for activities that have a preparatory or auxiliary character for the enterprise will also not constitute a permanent establishment. Among activities that have a preparatory or auxiliary character are advertising, supplying information and conducting scientific activities. If an enterprise uses a fixed place of business solely for any combination of the activities listed in paragraph 3, that use will not constitute a permanent establishment for the enterprise.

Paragraphs 5 and 6 of the Article as amended by the Protocol specify when the use of an agent will constitute a permanent establishment. Under both paragraphs as amended by the Protocol, the test for whether an agent will constitute a permanent establishment of the enterprise is more restrictive than under those paragraphs in the Convention. Paragraph 5 provides that a dependent agent of an enterprise will be deemed to be a permanent establishment of the enterprise, if the agent has, and habitually exercises, an authority to conclude contracts in the name of that enterprise. If, however, the agent's activities are limited to those activities specified in paragraph 4 which would not constitute a permanent establishment if those activities were carried on by the enterprise through a fixed place of business, the agent will not be a permanent establishment of the enterprise. Under paragraph 6, an enterprise will not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business.

Paragraph 7 is not amended by the Protocol. It clarifies that a company that is a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it controls or is controlled by a company that is a resident of the other Contracting State, or that carries on business in that other State. The determination of whether or not a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether or not a company is a permanent establishment of a related company, therefore, is based solely on those factors, and not on the ownership or control relationship between the companies.

Article II

Article II of the Protocol amends paragraph 1 of Article 7 (Business Profits) of the Convention to delete the "limited force of attraction" feature of the paragraph in the Convention, which was based on Article 7 of the U.N. Model. As amended, the paragraph conforms to that in the U.S. Model.

Paragraph 1 of Article 7 states the general rule of the Article, that business profits (as defined in paragraph 8) of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on, or has carried on, business in the other State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated in that other State. Where that condition is met, the State in which the permanent establishment exists, or existed, may tax the income of the enterprise, but only so much of it as is attributable to the permanent establishment. Under the Convention, the Contracting State in which the permanent establishment exists has a broader taxing right. It may tax, in addition to income attributable to the permanent establishment, income of the enterprise from sales of goods in that State or from activities carried on there, if the permanent establishment sells similar goods or carries on similar activities.

The reference in paragraph 1 to a permanent establishment that "carries on or has carried on" business is intended to incorporate the rule of section 864(c)(6) of the Internal Revenue Code ("Code") into the Convention. Like the Code section on which it is based, paragraph 1 provides that income attributable to a permanent establishment during its existence is taxable in the Contracting State where the permanent establishment is situated, even if the payments are deferred until after the permanent establishment no longer exists.

Article III

Article III of the Protocol amends Article 10 (Dividends) of the Convention in several respects, consistent with current U.S. treaty policy. Paragraph 1 of Article III of the Protocol adds special rules to paragraph 2 of Article 10 (Dividends) of the Convention for determining the rate of withholding at source on dividends paid by a U.S. Regulated Investment Company (RIC) or Real Estate Investment Trust (REIT). Both RIC and REIT dividends are denied the 5 percent direct investment dividend withholding rate that is otherwise applicable when the shareholder is a Barbados corporation that owns more than 10 percent of the shares of the RIC or REIT. RIC dividends are subject to the 15 percent portfolio investment dividend withholding rate. REIT dividends are subject to the 15 percent withholding rate if the shareholder is an individual who holds less than a 10 percent interest in the REIT.

In all other cases, REIT dividends are subject to withholding at the statutory rate of 30 percent.

Paragraph 2 of Article III of the Protocol amends the second sentence of paragraph 5 of Article 10 (Dividends) of the Convention. The text of the Convention as it was signed in 1984 exempts a Barbadian company from the U.S. accumulated earnings tax if individual residents of Barbados who are not also U.S. citizens control, directly or indirectly, throughout the last half of the taxable year, 50 percent or more of the entire voting power of the company. In giving its advice and consent to ratification, the Senate imposed a reservation on this sentence, under which the words "voting power" would be understood to mean "voting power or value". The reservation was introduced to conform the treaty rule to sec. 535(d) of the Code. The reservation was accepted by Barbados, and, therefore, the Convention should be read as amended by the reservation. The Protocol adds the words "or value" to the text, so that the meaning of the provision will be accurately reflected in the formal text. It does not, therefore, alter the meaning of the Convention.

Paragraph 3 of Article III of the Protocol modifies paragraph 6 of Article 10 (Dividends) of the Convention. The amendment deletes the rule that preserves the U.S. "second withholding tax" on dividends.

As amended, paragraph 6 prohibits one Contracting State from taxing the dividends paid by a company resident in the other, regardless of whether the dividends are paid out of profits earned in that other State, except in two circumstances. If the dividends are paid to a resident of the other State, that other State may tax the dividend income as part of the worldwide income of its resident. Similarly, if the dividends are attributable to a permanent establishment or a regular base situated in the other State, that other State may tax the income as part of the income attributable to the permanent establishment or regular base.

Article IV

Article IV of the Protocol amends paragraph 1 of Article 11 (Interest) of the Convention to reduce the general rate of tax at source on interest derived from sources within one Contracting State and beneficially owned by a resident of the other from 12.5 percent of the gross amount of the interest to 5 percent. An exception in the Convention to the general rate is not altered by the Protocol. Under the exception, interest derived from sources in a Contracting State and beneficially owned by a resident of the other is exempt from tax at source if the interest is paid in respect of a bond, debenture or other similar obligation issued, guaranteed or insured by the Government of the source State or by

a political subdivision, local authority or instrumentality of that Government.

Article V

Article V of the Protocol amends paragraph 2 of Article 12 (Royalties) of the Convention to reduce the rate of tax at source on royalties arising in one Contracting State and beneficially owned by a resident of the other from 12.5 percent of the gross amount of the royalties to 5 percent.

Article VI

Article V of the Protocol introduces a new Article 13A (Branch Tax) into the Convention. Article 13A explicitly confirms the right of each Contracting State to impose taxes on the income of an enterprise of the other Contracting State under specified circumstances, in addition to the taxes that may be imposed under the other articles of the Convention. The Article defines the base and rate of those taxes, and the conditions under which they may be imposed. In the case of the United States, the taxing rights confirmed and preserved are those granted with respect to the "dividend equivalent amount" and "excess interest" under section 884 of the Code. The Convention, absent Article 13A, merely preserves, by means of an exception to the nondiscrimination provisions in paragraph 2 of Article 24 (Nondiscrimination), the right of a Contracting State to impose these taxes, but does not does not provide specific guidance regarding their imposition.

Paragraph 1 merely provides for the imposition by one Contracting State of an additional tax on the income of an enterprise of the other Contracting State. The taxes are defined, for the United States and Barbados, in paragraph 2, and the rates are specified in paragraph 3.

Paragraph 2(a)(i) provides for the imposition by the United States of tax on the "dividend equivalent amount", under section 884(a) of the Code. It permits the United States to impose an additional tax on a company that is a resident of Barbados and that either has income attributable to a permanent establishment in the United States or that is subject to net-basis taxation on real property income in the United States either under Article 6 (Income from Real Property (Immovable Property)) or under paragraph 1 of Article 13 (Gains).

The term "dividend equivalent amount" is not defined in the Convention or the Protocol. It is, therefore, to be defined in accordance with section 884(b) of the Code and the regulations thereunder, as the term may be amended from time to time without changing the general principle thereof. Generally, the dividend

equivalent amount is the amount of the earnings and profits of the foreign corporation that are effectively connected (or treated as effectively connected) with the conduct of its trade or business in the United States, after payment of the U.S. corporate income tax, and decreased by any increase during the taxable year in the corporation's U.S. net assets ("U.S. net equity") or increased by any decrease in its U.S. net equity. The dividend equivalent amount is an approximation of the amount that would be distributed as a dividend if the permanent establishment were operating as a locally incorporated subsidiary.

Thus, for example, under paragraph 2(a)(i), the United States may impose its branch profits tax on the business profits of a Barbadian company attributable to the company's permanent establishment in the United States. In addition, the United States may impose this tax on income of a Barbadian corporation that is, in accordance with the Convention, subject to taxation under internal U.S. law on a net basis either because the Barbadian corporation has elected under Code section 882(d) to treat income from real property not otherwise taxed on a net basis as effectively connected income, or because the income is gain which is taxable on a net basis, such as gain that arises from the disposition of a United States real property interest (other than, under current U.S. law, an interest in a U.S. corporation). The United States may not impose its branch profits tax on the profits of a Barbadian corporation that are effectively connected with a U.S. trade or business but that are not included within the categories enumerated in the Protocol.

Paragraph 2(b)(i) provides for the imposition, to the extent such imposition is also provided for in Barbados law, of a comparable tax by Barbados on the income of a Barbados branch of a U.S. company, or on a U.S. company otherwise subject to net basis tax in Barbados (e.g., on income from the ownership or alienation of real property in Barbados). The base for the Barbadian tax is defined by analogy to the base for the U.S. tax in paragraph 2(a)(i), and, therefore, to section 884 of the Code and the regulations thereunder.

Subparagraph 2(a)(ii) provides for the imposition of the U.S. tax on excess interest. The excess interest tax can be viewed as a withholding tax on deemed interest payments from the U.S. branch of a foreign corporation to its head office. Under section 884(f)(1)(B) of the Code, excess interest is the excess of the total amount allowable as a deduction in computing the U.S. effectively connected income of a foreign corporation over the total interest paid by the foreign corporation's U.S. trade or business. Under the Convention as amended by the Protocol, the tax on excess interest applies only to the excess of interest which is deductible (1) in computing the U.S. tax on net profits that are attributable to a permanent establishment of a Barbados corporation in the United States, and (2) in computing the U.S. tax on net

income or gain from real property (other than, under current U.S. law, gain on shares in a U.S. corporation), over the interest paid by the foreign corporation's U.S. permanent establishment or U.S. trade or business. It is understood that interest paid is determined without regard to capitalized interest.

Subparagraph 2(b)(ii) provides for the imposition of a tax in Barbados, to the extent consistent with Barbados law, that is comparable to the U.S. tax on excess interest. Thus, a U.S. company that has a permanent establishment in Barbados or that is subject to Barbados tax on a net basis, may also be taxed by Barbados on the excess of the interest which it may deduct in computing its Barbados tax over the interest paid by the permanent establishment or by the net-taxed trade or business in Barbados.

Paragraph 3 specifies the rates applicable to the taxes on dividend equivalent amount and excess interest. The taxes described in paragraphs 2(a)(i) and 2(b)(i) (i.e., the U.S. and Barbadian taxes on dividend equivalent amount), are subject to tax at a rate not to exceed the 5 percent rate applicable to direct investment dividends under paragraph 2(a) of Article 10 (Dividends).

The U.S. and Barbadian taxes on excess interest, described in paragraphs 2(a)(ii) and 2(b)(ii) respectively, may be imposed at the appropriate rate specified in paragraph 2 of Article 11 (Interest). That paragraph, as amended by the Protocol, provides for two rates of tax at source on interest. A general rate of 5 percent is applicable to most payments of interest derived from sources in one Contracting State and beneficially owned by a resident of the other. The paragraph also provides for exemption at source for interest derived from sources in one Contracting State and beneficially owned by a resident of the other, if the interest is paid in respect of a bond, debenture or other similar obligation issued, guaranteed or insured by the Government of that Contracting State, or by a political subdivision, local authority or instrumentality of that Government. It is possible that the zero rate may apply where a government instrumentality of one Contracting State carries on business in the other.

Article VII

Article VII of the Protocol deletes Article 22 of the Convention (Limitation on Benefits) and replaces it with a new Limitation on Benefits Article. The revised Article is identical in substance to the anti-treaty-shopping provisions used in several U.S. tax treaties (e.g., Germany) negotiated and ratified after the 1984 U.S.-Barbados Convention was negotiated.

The Article assures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the

intended beneficiaries -- residents of the other Contracting State that have a substantial nexus with that State. The provision, therefore, limits opportunities for residents of third States to enter into arrangements to claim benefits under the treaty. For example, a resident of a third State might establish an entity in a Contracting State for the purpose of deriving income from the other Contracting State and claiming source-State benefits with respect to that income. Absent Article 22, the entity would generally be entitled to benefits as a resident of a Contracting State, subject, however, to such limitations (e.g., business purpose, substance-over-form, step transaction or conduit principles) as may be applicable to the transaction or arrangement under the domestic law of the source State.

The structure of the Article is as follows: Paragraph 1 lists a series of attributes of a resident of a Contracting State, the presence of any one of which will entitle that person to benefits of the Convention in the other Contracting State. Most of these are purely objective tests. One, in subparagraph (c), is more subjective, and requires some elaboration and interpretation. Paragraph 2 provides that benefits may be granted even to a person not entitled to benefits under the tests of paragraph 1, if the competent authority of the source State so determines. Paragraph 3 defines the term "recognized stock exchange", as used in paragraph 1. Paragraph 4 authorizes the competent authorities to develop agreed applications of the Article and to exchange information necessary for carrying out the provisions of the Article.

A Memorandum of Understanding was developed by the negotiators indicating how certain provisions of the Article are to be understood both by the competent authorities and by taxpayers in the Contracting States. It is anticipated that as the competent authorities and taxpayers gain more experience with the concepts of this Article, further guidance will be developed and made public.

Two categories of persons eligible for benefits from the other Contracting State under subparagraphs (a) and (b) of paragraph 1 are (1) individual residents of a Contracting State and (2) the Contracting States, or political subdivisions or local authorities thereof. It is most unlikely that persons falling into one of these two categories can be used to derive treaty-benefitted income on behalf of a third-country person. If an individual is receiving income as a nominee on behalf of a third-country resident, benefits will be denied with respect to those items of income under the articles of the Convention which grant the benefits, because of the requirement in those articles that the beneficial owner of the income be a resident of a Contracting State.

Under subparagraph (d) of paragraph 1, a corporation which is a resident of a Contracting State is entitled to treaty benefits from the other Contracting State if there is substantial and

regular trading in the corporation's principal class of shares on a recognized stock exchange. The term "recognized stock exchange" is defined in paragraph 3 of the Article to mean the NASDAQ System and any stock exchange which is registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, and any other exchange agreed upon by the competent authorities.

Subparagraph (e) provides a two-part test, the ownership and base erosion tests, both of which must be satisfied for entitlement to benefits under this subparagraph. Under these tests, benefits will be granted to a resident of a Contracting State other than an individual if both (1) more than 50 percent of the beneficial interest in the person (or, in the case of a corporation, more than 50 percent of the number of shares of each class of its shares) is owned, directly or indirectly, by persons who are themselves entitled to benefits under the other tests of paragraph 1 (other than subparagraph (c)) or by U.S. citizens, and (2) no more than 50 percent of the person's gross income is used, directly or indirectly, to make deductible payments to persons who are not themselves eligible for benefits under the other tests of paragraph 1 (other than subparagraph (c)), or are not U.S. citizens. It is understood that the term "gross income" is to be interpreted as under internal U.S. law. Thus, in general, the term should be understood to mean gross receipts less cost of goods sold.

The rationale for this two-part test is that since treaty benefits can be indirectly enjoyed not only by equity holders of an entity, but also by that entity's various classes of obligees, such as lenders, licensors, service providers, and others, it is not enough, in order to prevent such benefits from inuring substantially to third-country residents, merely to require substantial equity ownership of the entity by treaty-country residents or their equivalent. It is also necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or their equivalents. Otherwise, for example, a third-country resident could lend funds to a Barbadian-owned Barbados corporation to be reloaned to the United States. The U.S. source interest income of the Barbadian corporation would be subject to U.S. withholding at a reduced rate of 5 percent under the Convention as amended by the Protocol. While the Barbadian corporation would be subject to Barbados corporate income tax, its taxable income could be reduced to near zero by the deductible interest paid to the third-country resident. If, under a Convention between Barbados and the third-country, that interest payment were subject to significantly reduced Barbados tax, or were exempted from tax, the bulk of the U.S. treaty benefit with respect to the U.S. source interest income would have flowed through to the third-country resident, notwithstanding the ownership of the Barbadian corporation by Barbadian residents.

Subparagraph (f) provides that a not-for-profit organization that is a resident of a Contracting State is entitled to benefits from the other Contracting State if it satisfies two conditions: (1) It must be generally exempt from tax in its State of residence by virtue of its not-for-profit status, and (2) more than half of the beneficiaries, members or participants, if any, in the organization must be persons entitled, under this Article, to the benefits of the Convention. The not-for-profit organizations dealt with in this subparagraph include pension funds, pension trusts, private foundations, trade unions, trade associations and similar organizations.

Subparagraph 1(c) of Article 22 provides a test for eligibility for benefits that looks not solely at objective characteristics of the person deriving the income, but at the nature of the activity engaged in by that person and the connection between the income and the activity. Under the subparagraph, a resident of a Contracting State deriving income from the other Contracting State is entitled to benefits if the person is engaged in an active trade or business in his State of residence, and the item of income in question is derived in connection with, or is incidental to, that trade or business. Income derived in connection with, or incidental to, the business of making or managing investments will not qualify for benefits under this provision unless the business is a bank or insurance company deriving the income from its banking or insurance activities.

In general, it is expected that if a person is entitled to benefits under one or more of the other subparagraphs of paragraph 1, no inquiry will be made into qualification for benefits under subparagraph 1(c).

Upon satisfaction of any of the other tests of paragraph 1, any income derived by the beneficial owner from the other Contracting State is entitled to treaty benefits. Subparagraph 1(c), however, is an item-of-income by item-of-income test, and, therefore, each item of income must be tested separately.

It is intended that the provisions of paragraph 1(c) will be self executing. Unlike the provisions of paragraph 2, discussed below, claiming benefits under this subparagraph does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the subparagraph and is not entitled to the benefits claimed.

A memorandum was exchanged at the time of the signing of the Protocol which suggests, by means of examples, the understandings reached by the negotiators as to the intended scope of subparagraph 1(c). These examples are reproduced in the following paragraphs. They are not intended to be exhaustive, but are merely illustrative

of the kinds of considerations that are relevant in making a determination under subparagraph 1(c).

Example I

Facts: A Barbadian resident company is owned by three persons, each resident in a different third country. The company is engaged in an active international marketing business in Barbados. It purchases goods in Asia and sells them throughout the Western Hemisphere, including the United States. It has a trade or business in the United States but no permanent establishment under Article 5 of the treaty. The Barbadian company is engaged in the United States in selling the goods which it has purchased in Asia. The active purchasing and selling business in Barbados of the Barbadian company is substantial in relation to the activities of the company's trade or business in the United States. Is the Barbadian company, by virtue of Articles 5 and 7 of the treaty, exempt from U.S. tax on its income effectively connected with its U.S. trade or business?

Analysis: Treaty benefits would be allowed, and the income would be exempt because the treaty requirement that the U.S. income is "derived in connection with or is incidental to" the Barbadian active business is satisfied. This conclusion is based on two elements in the fact pattern presented: (1) the income is connected with the active Barbadian business -- in this example in the form of a "downstream" connection; and (2) the active Barbadian business is substantial in relation to the business carried on in the United States.

Example II

Facts: The facts are the same as in Example I except that while the income is derived by a Barbadian company of which the U.S. trade or business is a part, the relevant business activity in Barbados (i.e., the worldwide purchasing and selling activity) is carried on by a Barbadian subsidiary company of the first company. The Barbadian subsidiary's activities meet the business relationship and substantiality tests of the business connection provision, as described in the preceding example. Is the effectively connected U.S. income of the U.S. trade or business exempt from U.S. tax under Articles 5 and 7 of the treaty?

Analysis: The income is exempt because the two Barbadian entities (i.e., the one deriving the income and the one carrying on the substantial active business in Barbados) are related. Benefits are not denied merely because the

income is earned by one Barbadian company and the relevant activity is carried on in Barbados by a related Barbadian company.

The existence of a similar multiple company structure in the United States would not affect the right of the Barbadian company receiving the income to treaty benefits. If, for example, a Barbadian company owns a subsidiary in the United States which is, itself, a holding company for the group's U.S. activities, and those activities are connected with the business activity of the parent or a related company in Barbados, dividends paid by the U.S. holding company to the Barbadian parent holding company would be tested for eligibility for benefits, in the same way as described above, ignoring the fact that the activities are carried on by one entity and the income in respect of which benefits are claimed is paid by another, related, entity.

Example III

Facts: A U.S. resident company is owned by three persons, each resident in a different third country. The company is the worldwide headquarters and parent of an integrated international business carried on through subsidiaries in many countries, including Barbados. The company's wholly owned U.S. and Barbadian subsidiaries manufacture, in their countries of residence, different products, each of which are part of the group's product line. The Barbadian subsidiary has been capitalized with debt and equity. The active manufacturing business of the U.S. subsidiary is substantial in relation to the activities of the Barbadian subsidiary. The U.S. parent manages the worldwide group and also performs research and development to improve the manufacture of the group's product line. Are the Barbadian subsidiary's dividend and interest payments to its U.S. parent eligible for treaty benefits in Barbados?

Analysis: Treaty benefits would be allowed because the treaty requirement that the Barbadian income is "derived in connection with or is incidental to" the U.S. active business is satisfied. This conclusion is based on two elements in the fact pattern presented: (1) the income is connected with the U.S. active business because the Barbadian subsidiary and the U.S. subsidiary each manufacture products which are part of the group's product line, the U.S. parent manages the worldwide group, and the parent performs research and development that benefits both subsidiaries; and (2) the active U.S. business is substantial in relation to the business of the Barbadian subsidiary.

Example IV

Facts: A third-country resident establishes a Barbadian company for the purpose of acquiring a large U.S. manufacturing company. The sole business activity of the Barbadian company (other than holding the stock of the U.S. company) is the operation of a small retailing outlet in Barbados which sells products manufactured by the U.S. company. Is the Barbadian company entitled to treaty benefits under paragraph 1(c) with respect to dividends it receives from the U.S. manufacturer?

Analysis: The dividends would not be entitled to benefits. Although there is, arguably, a business connection between the U.S. and the Barbadian businesses, the "substantiality" test described in the preceding examples is not met.

Example V

Facts: U.S., French and Canadian companies create a joint venture in the form of a partnership organized in the United States to manufacture a product in a developing country. The joint venture owns a Barbadian sales company which pays dividends to the joint venture. Are these dividends eligible for reduced Barbadian withholding under the U.S.-Barbados treaty?

Analysis: Under Article 4, only the U.S. partner is a resident of the United States for purposes of the treaty. The question arises under this treaty, therefore, only with respect to the U.S. partner's share of the dividends. If the U.S. partner meets the public trading or ownership and base erosion tests of subparagraphs 1(d) or (e), it is entitled to benefits without reference to paragraph 1(c). If not, the analysis of the previous examples would be applied to determine eligibility for benefits under 1(c). The determination of Barbadian treaty benefits available to the French and Canadian partners will be made under Barbadian treaties with France and Canada, or, in the absence of such treaties, under the provisions of Barbados law.

Example VI

Facts: A Barbadian company, a Jamaican company and a Trinidadian company create a joint venture in the form of a Barbadian resident company in which they take equal shareholdings. The joint venture company engages in an active data processing business in Barbados. Income derived from that business that is retained as working capital is invested in U.S. Government securities and other U.S.

debt instruments until needed for use in the business. Is interest paid on these instruments eligible for U.S.-Barbados treaty benefits?

Analysis: The interest would be eligible for treaty benefits. Interest income earned from short-term investment of working capital is incidental to the business in Barbados of the Barbadian joint venture company.

Paragraph 2 of Article 22 provides that a resident of a Contracting State that derives income from the other Contracting State and is not entitled to the benefits of the Convention under any of the provisions of paragraph 1, may, nevertheless, be granted benefits at the discretion of the competent authority of the Contracting State in which the income arises. The paragraph itself provides no guidance to competent authorities or taxpayers as to how the discretionary authority is to be exercised. The Memorandum of Understanding does provide some discussion and guidance. Relevant portions of that memorandum are reproduced in the discussion that follows.

It is assumed that, for purposes of implementing paragraph 2, taxpayers will be permitted to present their cases to the competent authority for an advance determination based on the facts, and will not be required to wait until the tax authorities of one of the Contracting States have determined that benefits are denied. In these circumstances, it is also expected that if competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

In making determinations under paragraph 2, it is understood that the competent authorities will take into account all relevant facts and circumstances. The factual criteria that the competent authorities are expected to take into account include the existence of a clear business purpose for the structure and location of the income-earning entity in question; the conduct of an active trade or business (as opposed to a mere investment activity) by such entity; and a valid business nexus between that entity and the activity giving rise to the income. The competent authorities will, furthermore, consider, for example, whether and to what extent a substantial headquarters operation conducted in a Contracting State by employees of a resident of that State contributes to such valid business nexus, and should not, therefore, be treated merely as the "making or managing [of] investments" within the meaning of paragraph 1(c) of Article 22.

The discretionary authority granted to the competent authorities in paragraph 2 is particularly important in view of, and should be exercised with particular cognizance of, the developments in, and objectives of, international economic integration, such as

that among the member countries of the CARICOM and under the North American Free Trade Agreement.

The following example illustrates the application of these principles:

Facts: Barbadian, Jamaican and Antiguan companies, each of which is engaged directly or through its affiliates in substantial active business operations in its country of residence, decide to cooperate in the development and marketing of a new computer spreadsheet program through a corporate joint venture with its statutory seat in Barbados. The development and marketing aspects of the project are carried out by the individual joint venturers. The joint venture company, which is staffed with a significant number of managerial and financial personnel seconded by the joint venturers, acts as the general headquarters for the joint venture, responsible for the overall management of the project, including coordination of the functions separately performed by the individual joint venturers on behalf of the joint venture company, development of sales strategies, and the investment of working capital contributed by the joint venturers and the financing of the project's additional capital requirements through public and private borrowings. The joint venture company derives portfolio investment income from U.S. sources generated by working capital investments. Is this income eligible for benefits under the U.S.-Barbados treaty?

Analysis: If the joint venture company's activities constitute an active business and the income is connected to that business, benefits would be allowed under paragraph 1(c). If not, it is expected that the U.S. competent authority would determine that treaty benefits should be allowed in accordance with paragraph (2) under the facts presented, particularly in view of (1) the clear business purpose for the formation and location of the joint venture company; (2) the significant headquarters functions performed by that company in addition to financial functions; and (3) the fact that all of the joint venturers are companies resident in CARICOM member countries in which they are engaged directly or through their affiliates in substantial active business operations.

The competent authorities will consult further on these issues and develop additional standards for the application of the Article as they gain experience with the application of these rules.

Paragraph 4 of Article 22 authorizes the competent authorities both to develop procedures for the application of the Article, and

to exchange information necessary to carry out its provisions. Thus, for example, if a Barbadian resident corporation claims benefits on the basis of having satisfied the ownership/base erosion tests of subparagraph 1(e), the U.S. competent authority may request information from the Barbados competent authority to confirm that these tests have, in fact, been satisfied.

Article VIII

Article VIII provides the rules for ratification and entry into force of the Protocol. The Protocol will be ratified in accordance with the normal procedures in both countries. Once both countries have concluded their ratification procedures, the Protocol will be brought into force by the exchange of instruments of ratification. The modification in withholding taxes under Articles 10 (Dividends), 11 (Interest), and 12 (Royalties), brought into the Convention by Articles III, IV and V of the Protocol, will take effect on the first day of the second month following the day on which the Protocol enters into force. All other modifications to the Convention resulting from the Protocol will take effect for taxable years beginning on or after the first day of January next following the day on which the Protocol enters into force.

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE UNITED STATES OF AMERICA AND THE RUSSIAN FEDERATION FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL SIGNED AT WASHINGTON ON JUNE 17, 1992

This is a technical explanation of the Convention and Protocol between the United States and Russia signed on June 17, 1992 ("the Convention"). The Convention replaces the Convention Between the United States of America and the Union of Soviet Socialist Republics for the Avoidance of Double Taxation of Income, the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Elimination of Obstacles to International Trade and Investment, signed on June 20, 1973 ("the 1973 Convention"), as it applied to the United States and Russia.

The Convention is based on the U.S. Treasury Department's draft Model Income Tax Convention, published on June 16, 1981 ("the U.S. Model"), the Model Double Taxation Convention on Income and Capital, published by the OECD in 1977 ("the OECD Model"), the 1973 Convention and other more recent U.S. income tax conventions. Although the U.S. Model has been withdrawn, and a new Model is being developed as this Technical Explanation is being prepared, the U.S. Model was the relevant Model at the time the Convention was negotiated.

The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention.

The explanations of each article include explanations of any Protocol provision relating to that article.

Article 1. GENERAL SCOPE

Paragraph 1 provides that the Convention applies to residents of the United States or Russia, and in some cases may also apply to residents of third States. Article 4 defines residents of the United States and Russia for the purposes of the Convention. Examples of cases where the Convention may affect residents of third States include the articles on non-discrimination (Article 23) and the exchange of information (Article 25).

Paragraph 2 is the same as the corresponding provision in the U.S. Model. The Convention may not increase the tax burden of residents of either State compared to what it would be under the

respective domestic law provisions. Thus, a right to tax given by the Convention cannot be exercised unless domestic law also provides for such a tax. This does not mean, however, that a taxpayer may pick and choose among Code and Convention provisions in an inconsistent manner in order to minimize tax. For example, assume a resident of Russia has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn income taxable in the United States under the Code but do not meet the permanent establishment threshold tests of the Convention. One is profitable, and the other incurs a loss. Under the Convention the income of the permanent establishment is taxable, and both the profit and loss of the other two businesses are ignored. Under the Code all three would be taxable. The loss would be offset against the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B. 10.) If the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States which is not effectively connected with any of his business activities in the United States.

Paragraph 3 contains the traditional "saving" clause, which provides that each country may tax in accordance with its domestic law, without regard to the Convention, it's own residents, citizens, and former citizens. "Residence", for the purpose of the saving clause, is determined under Article 4 (Residence). Thus, for example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, e.g. a "green card" holder, and is also a resident of Russia under Russian law, and the tie-breaker rules of paragraph 2 of Article 4 determine that he is a resident of Russia, he will be entitled to U.S. benefits under the Convention. The paragraph also permits the taxation of certain former citizens. In the case of the United States, citizens whose loss of citizenship had as one of its principal purposes the avoidance of U.S. tax may be taxed in accordance with section 877 of the Internal Revenue Code. There is not a comparable provision in Russian law dealing with former citizens.

As a consequence of the saving clause, each article should be read as not providing benefits with respect to the U.S. taxation of U.S. citizens (wherever resident) or residents or with respect to Russian taxation of Russian citizens or residents. However, paragraph 4 provides certain exceptions to the saving clause. Under subparagraph a), for example, U.S. residents and citizens are entitled to certain U.S. benefits provided under the Convention. Those benefits are: the correlative adjustments authorized by paragraph 2 of Article 7, the exemption of social security benefits paid by the other State that is provided in paragraph b) of Article

17, the guarantee of a foreign tax credit provided in Article 22, the nondiscrimination protection of Article 23 and the competent authority procedures of Article 24. Under subparagraph b) certain additional benefits are available to U.S. residents who are neither U.S. citizens nor "green card" holders; these are the benefits extended to employees of the Russian Government under Article 16, to visiting students, trainees and researchers under Article 18, and to members of diplomatic and consular missions under Article 26. This paragraph also applies reciprocally.

Article 2. TAXES COVERED

This Article identifies the U.S. and Russian taxes to which the Convention applies.

In the case of the United States, the Convention applies to the Federal income taxes imposed by the Internal Revenue Code, but not including the accumulated earnings tax or personal holding company tax (which are considered penalty taxes) or social security taxes. It also applies to the excise taxes imposed with respect to the investment income of private foundations. The non-discrimination provisions of Article 23 apply to all taxes imposed at all levels of government. This is the only article that applies to state and local taxes. The exchange of information provisions of Article 25 apply to all Federal level taxes, e.g. including estate and gift and excise taxes to the extent that such information is relevant to enforcement of the Convention or of any covered tax as long as such tax is applied in a manner that is not inconsistent with the Convention.

In the case of Russia, the Convention applies to the taxes on profits and income provided by the enumerated Russian laws. The non-discrimination provisions of Article 23 extend to all taxes at all levels of government and the exchange of information provisions of Article 25 extend to all national-level taxes. The reference in subparagraph 1(b) to the tax "on profits" is not meant to infer that such taxes are not income taxes in the U.S. sense. In fact, the term "profits" in Russian generally refers to a net income concept, although there may be limits on certain deductions, whereas "income" generally applies to profits plus wages paid.

Under paragraph 2, the Convention will apply to any taxes that are substantially similar to those enumerated in paragraph 1, and that are imposed in addition to, or in place of, the existing taxes after June 17, 1992 (the date of signature of the Convention). In recognition of the fact that the Russian tax system is evolving, the paragraph adds that a subsequent tax imposed by one State that is substantially similar to an existing tax of the other State covered by paragraph 1 will also be covered. For the same reason, paragraph 3 also includes in the Convention's coverage any national

level tax on capital subsequently imposed by either Contracting State.

Paragraph 2 also provides that the U.S. and Russian competent authorities will notify each other of significant changes in their taxation laws. This refers to changes that are of significance to the operation of the Convention.

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines a number of basic terms used in the Convention. Certain others are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Residence). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). The terms "dividends", "interest" and "royalties" are defined in Articles 10, 11 and 12, respectively, which deal with the taxation of those classes of income.

The term "Contracting State" means the United States or Russia, depending on the context in which the term is used.

The terms "United States" and "Russia" are defined in subparagraphs b) and c), respectively. The term "United States" is defined to mean the United States of America. The term does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When used geographically, the "United States" includes the territorial sea, the continental shelf and the economic zone of the United States, provided that any taxation therein is in accordance with international law and U.S. tax law. Currently, U.S. tax law applies on the continental shelf only with respect to the exploration for and exploitation of mineral resources. (Code section 638.) The term "Russia" means the Russian Federation and, when used geographically, includes the territorial sea, the continental shelf, and the economic zone, provided that any taxation therein is in accordance with international law and Russian tax law.

Subparagraph d) defines the term "person" to include an individual, an estate, a trust, a partnership, a company and any other body of persons. This conforms to the definition in the U.S. Model. Any such person may be a "resident" of a Contracting State for purposes of Article 4 and thus entitled to the benefits of the Convention.

The term "company" is defined in subparagraph e) as any entity treated as a body corporate for tax purposes. In Russia, this includes a joint stock company, a limited liability company, a joint venture, and any other legal entity or an organization subject to the tax on profits in Russia. For U.S. tax purposes, the rules of Reg. § 301.7701-2 generally will be applied to

determine whether an entity is a body corporate. However, Russian entities described in the second sentence of subparagraph (c) are treated as companies for all purposes of the treaty.

The Convention is drafted to refer to "residents" rather than "enterprises". The Russian delegation observed that the U.S. and OECD Models do not provide an adequate definition of an "enterprise of a Contracting State". Thus, it was decided to use instead the term "resident".

Subparagraph f) defines the term "international traffic". The term means any transport by a ship or aircraft except when such transport is solely between places within a Contracting State. The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that the transport of goods or passengers solely between New York and Chicago by a Russian carrier (if it were permitted) would not be treated as international traffic, and the resulting income would not be exempt from U.S. tax under Article 8. It would however, be treated as business profits under Article 6 and would, therefore, be taxable in the United States only if attributable to a U.S. permanent establishment, and then only on a net basis. If, however, goods or passengers are carried by a Russian plane from Moscow to New York and then to Chicago, the trip would be international transport with respect to the carriage for those who continued to Chicago as well as for those who disembarked in New York.

Subparagraph g) defines the term "capital". The definition is relevant for possible future enactment of a tax on capital by either Contracting State. (See Article 21 (Capital).)

The "competent authority" is the Government official charged with administering the provisions of the Convention and with attempting to resolve any doubts or difficulties which may arise in interpreting its provisions. The U.S. competent authority is the Secretary of the Treasury or his authorized representative. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who has, in turn, delegated the authority to the Assistant Commissioner (International). With respect to interpretive issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service. In Russia, the competent authority is the Minister of Finance or his authorized representative. In general that function is assigned to the Deputy Minister of Finance or the Chief of the Department of Tax Reform.

Paragraph 2 provides that, in the application of the Convention, any term used but not defined in the Convention will have the meaning which it has under the law of the Contracting State whose tax is being applied, unless the context requires a

different interpretation or the competent authorities agree to a common meaning.

Article 4. RESIDENCE

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. Determination of residence is important because, as noted in the explanation to Article 1 (General Scope), as a general matter only residents of the Contracting States may, subject to Article 20 (Limitation on Benefits), claim the benefits of the Convention. This definition of residence is to be used only for purposes of the Convention.

The determination of residence for purposes of the Convention looks first to a person's liability to tax as a resident under the respective taxation laws of the Contracting States. For this purpose, liability to tax is interpreted as subject to the taxation laws; thus, a tax-exempt entity may be a resident of a Contracting State. A person who, under those laws, is a resident of one Contracting State and not of the other need look no further. That person is a resident for purposes of the Convention of the State in which he is resident under internal law. Like the U.S. Model, this Convention includes citizenship as one of the criteria of residence. Thus, a U.S. citizen resident in a third country is entitled to the benefits of this Convention on the same basis as an individual residing in the United States. If, however, a U.S. citizen or resident (e.g., a "green card" holder) is also a resident of Russia under its taxation law, the individual must look to the tie-breaker rules of paragraph 2, which attempt to assign one State of residence to such a person for purposes of the Convention. The U.S. citizen would continue to be subject to U.S. taxation under the saving clause of paragraph 3 of Article 1 (General Scope), but the green card holder's residence would be determined only under this Article for purposes of Convention benefits.

It is understood that the two Contracting States and their political subdivisions are to be treated as residents of those States for purposes of Convention benefits.

A person that is liable to tax in a Contracting State only in respect of income from sources within that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, a Russian consular official in the United States who is subject to U.S. tax on U.S. source investment income, but not on non-U.S. income, would not be considered a resident of the United States for purposes of the Convention. (In most cases such an individual also would not be a U.S. resident under the Code.)

A partnership, estate or trust will be treated as a resident of a Contracting State in accordance with the residence of the person liable to tax with respect to the income derived by the partnership, estate, or trust, i.e. to the extent that the income is taxed as the income of a resident, whether in the hands of the person deriving the income or in the hands of its partners or beneficiaries. This rule is applied to determine the extent to which the partnership, estate or trust is entitled to benefits with respect to income derived from the other Contracting State. Under Russian law a partnership is generally taxed as an entity, and trusts and estates are not used. Under U.S. law, a partnership is never (except for certain publicly traded limited partnerships and partnerships that are reclassified as associations under Reg. § 301.7701-2), and an estate or trust is often not, a taxable entity. Thus for purposes of the Convention, income received by a U.S. partnership need only be treated as received by a U.S. resident to the extent included in the distributive share of partners who are U.S. residents (looking through any partnerships which are themselves partners). Similarly, the treatment under the Convention of income received by a U.S. trust or estate will be determined by the residence for taxation purposes of the person subject to tax on such income, which may be the grantor, the beneficiaries, or the estate or trust itself, depending on the particular circumstances.

If, under the laws of the two Contracting States, and, thus, under paragraph 1, an individual is deemed to be a resident of both Contracting States, a series of tie-breaker rules is provided in paragraph 2 to determine a single State of residence for that individual. These rules come from the OECD Model. The first test is where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State where his personal and economic relations are closest, i.e., the location of his "center of vital interests". If that test is also inconclusive, or if he does not have a permanent home available to him in either State, he will be treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither of them, he will be treated as a resident of his Contracting State of citizenship. If he is a citizen of both States or of neither, the competent authorities are instructed to resolve his residence by mutual agreement.

Paragraph 3 seeks to settle dual residence issues for companies (defined in Article 3 as entities treated as a body corporate for tax purposes). A company is treated as resident in the United States if it is created or organized under the laws of the United States or a political subdivision. In Russia, a company is treated as a resident if its place of registration is in Russia. In most cases it is expected that the place of incorporation and registration will be the same. However, in the event that a

company is a resident of both countries under their respective domestic laws, this paragraph provides that the competent authorities will endeavor to establish a single country of residence. If they are unable to do so, the company will not be entitled to claim the benefits of the Convention as a resident of either Contracting State. It will continue to be considered a resident of both States for purposes of providing benefits to persons who are entitled to Convention benefits (e.g. the reduced rates or exemption at source of dividends, interest and royalties will apply to such payments by a dual resident company to a resident of one of the Contracting States) and for purposes of the domestic taxation laws of the two States.

Paragraph 4 provides that where a person, other than an individual or a company, is a resident of both Contracting States under their respective laws, the competent authorities will establish a single country of residence and agree on how the Convention is to apply to such a person.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment", which is relevant to several articles of the Convention. The current or former existence of a permanent establishment in a Contracting State is necessary under Article 6 (Business Profits) for that State to tax the business profits of a resident of the other Contracting State. Articles 10, 11 and 12 (dealing with dividends, interest, and royalties, respectively) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment or fixed base which the recipient has in the source State; if the income is or was attributable to a permanent establishment, Article 6 (Business Profits) applies (and if the income is or was attributable to a fixed base, Article 13 (Independent Personal Services) applies).

This Article is similar in most respects to the corresponding Articles of the U.S. and OECD Models, but includes some departures from those Models.

Paragraph 1 provides the basic definition of the term "permanent establishment". As used in the Convention, the term means a fixed place of business through which a resident of one Contracting State carries on business activities in the other Contracting State. It is not necessary that the resident be a legal entity. In the case of an individual, Article 13 (Independent Personal Services) uses the concept of a "fixed base" rather than a "permanent establishment", but the two concepts are considered to be parallel.

Paragraph 2 contains a list of examples of fixed places of business which constitute a permanent establishment: a place of management, a branch, an office, a factory, a workshop, and a mine, well, quarry or other place of extraction of natural resources.

Paragraph 3 adds that a construction site, installation or assembly project, or an installation or drilling rig or ship used to explore for or exploit natural resources also constitutes a permanent establishment, but only if it lasts more than 18 months. This is a compromise between the 12 months provided for in the U.S. and OECD models and the 36 months provided in the 1973 Convention for technical services performed in connection with an installation contract. It was agreed that some period longer than 12 months was appropriate to take into account the time needed to complete modest projects, including securing the necessary permits and supplies, but that it was not the intent to exclude large projects from the definition. The 18-month test applies separately to each individual site or project. The period begins when work (including preparatory work carried on by the resident) physically begins in a Contracting State. A series of contracts or projects that are interdependent both commercially and geographically is to be treated as a single project. For example, the construction of a housing development would be considered a single project even if each house is constructed for a different purchaser. If the 18-month threshold is exceeded, the site or project constitutes a permanent establishment from its first day. This interpretation of the Article is based on the Commentaries to paragraph 3 of Article 5 of the OECD Model, which constitute the generally accepted international interpretation of the language in paragraph 3 of Article 5 of the Convention. Drilling rigs, both onshore and offshore, are covered by this rule, and must, therefore, be present in a Contracting State for 18 months to constitute a permanent establishment.

Paragraph 4 contains exceptions to the general rule of paragraph 1 that a fixed place of business through which a business is carried on constitutes a permanent establishment. The paragraph lists a number of activities that may be carried on through a fixed place of business, but that, nevertheless, will not give rise to a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise will not constitute a permanent establishment of that enterprise. The maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise will not give rise to a permanent establishment of the first-mentioned enterprise. The maintenance of a fixed place of business solely for purchasing goods or collecting information for the resident, or for carrying out any other activity of a preparatory or auxiliary character for the resident, such as advertising, the supply of information, or certain research activities, will not constitute a permanent establishment of the resident.

Subparagraph g) was added, at the suggestion of the Russian delegation, to clarify that a U.S. company that uses a place of business, such as a representative office, solely to facilitate the conclusion of, or for the signing of, contracts in its own name for loans or the furnishing of goods or technical services does not thereby have a permanent establishment.

A combination of the activities described in paragraph 4 will not give rise to a permanent establishment.

Paragraphs 5 and 6 specify when the use of an agent will constitute a permanent establishment where a permanent establishment does not otherwise exist under paragraphs 1 through 4. Under paragraph 5, a dependent agent of an enterprise will be deemed to be a permanent establishment of the enterprise, if the agent has and habitually exercises an authority to conclude contracts in the name of that enterprise. If, however, his activities are limited to those activities specified in paragraph 4 that would not constitute a permanent establishment if carried on directly by the enterprise through a fixed place of business, the agent will not be a permanent establishment of the enterprise.

Under paragraph 6, an enterprise will not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business.

Paragraph 7 clarifies that a company that is a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it controls, or is controlled by, a company that is a resident of that other Contracting State, or that carries on business in that other Contracting State. The determination of whether a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

Article 6. BUSINESS PROFITS

The location of this Article and the articles on real property income and related persons were changed from those of the U.S. and OECD Models, in response to the suggestion of the Russian delegation that this is a more logical ordering of the subject matter.

This Article provides the rules for the taxation by a Contracting State of the business profits of a resident of the other Contracting State. The general rule is found in paragraph 1,

that business profits (as defined in paragraph 5) of a resident of one Contracting State may not be taxed by the other Contracting State unless the resident carries on or has carried on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated in the latter State. Where that condition is met, the State in which the permanent establishment is situated may tax the business profits attributable to the assets or activity of that permanent establishment.

Subparagraph a) of paragraph 1 of the Protocol to the Convention provides two examples of the "attributable to" concept. One concerns a resident of one Contracting State that has a construction site in the other Contracting State that constitutes a permanent establishment under Article 5, and also uses a place of business in that other State for the signing of contracts for the sale of equipment for another project. The contracts are not negotiated in that other State. The two activities are separate; the mere signing of contracts in one's own name is not a permanent establishment, so any profits from the equipment sales are not taxed in the latter State. The second example concerns a company that is engaged in oil production through a well or wells located in the other State. The company also carries on exploration activities at another location in that other State using assets and employees not connected with the production activities; the activities last less than 18 months. The company also occasionally leases drilling equipment to third parties. The three activities are separate. The oil production constitutes a permanent establishment and the resulting profits are taxable in that other State. The other two activities do not constitute permanent establishments, and any resulting profits may not be taxed in that other State. The reference to "a well" is not intended to imply that each well site constitutes a separate permanent establishment; multiple well sites comprise a single permanent establishment if they represent a commercially and geographically unified project.

Paragraph 2 provides that the Contracting States will attribute to a permanent establishment the profits that it would be expected to make if it were an independent entity, engaged in the same or similar activities under the same or similar conditions. Profits so attributable to a permanent establishment are taxable in the State where the permanent establishment is situated or was situated at the time the profits were made. This rule incorporates the rule of section 864 (c)(6) of the Internal Revenue Code with respect to deferred payments, which is also reflected in the provisions of Articles 11 (Interest), 12 (Royalties), 13 (Independent Personal Services) and 19 (Other Income) dealing with amounts attributable to a permanent establishment or fixed base. If the income was attributable to a permanent establishment or fixed base when earned, it is taxable by the State where the permanent establishment or fixed base was located, even if receipt

of the income is deferred until the permanent establishment or fixed base has ceased to exist.

The profits attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, certain items of foreign source income described in section 864(c)(4)(B) or (C) of the Code may be attributed to a U.S. permanent establishment of a Russian resident and subject to tax in the United States. The concept of "attributable to" in the Convention is narrower than the concept of "effectively connected" in section 864(c) of the Code. The limited "force of attraction" rule in Code section 864(c)(3), therefore, is not applicable under the Convention.

Paragraph 3 provides that the tax base must be reduced by deductions for expenses incurred for the purposes of the permanent establishment. These include expenses directly incurred by the permanent establishment and a reasonable allocation of expenses incurred by the home office, or by other parts of the enterprise company, as long as the expenses were incurred on behalf of the company as a whole, or a part of it that includes the permanent establishment. Allocable expenses would include executive and general administrative expenses, research and development expenses, interest, and charges for management, consultancy, or technical assistance, wherever incurred and without regard to whether they are actually reimbursed by the permanent establishment. The permanent establishment must be able to document such expenses, if so requested by the tax authorities of the State in which it is located. (See also subparagraphs b) and d) of paragraph 1 of the Protocol.)

Subparagraph c) of paragraph 1 of the Protocol provides a full deduction of interest expense to a permanent establishment in Russia of a U.S. company, provided that the amount does not exceed the greater of the limitation specified in Russian law or the London Inter-bank Offered Rate (LIBOR) plus a reasonable risk premium, specified in the loan contract. Currently, the limitation specified in Russian law is high, so it does not represent an effective limit on the deduction with respect to dollar loans. However, in most cases only interest paid on bank loans of less than one year is permitted as a deduction under Russian law. The Protocol removes this restriction for permanent establishments of U.S. residents. By statute permanent establishments are allowed a full deduction for wages (with the possible exception of bank branches about which there was some uncertainty; however, branches of U.S. banks are guaranteed a full deduction for wages as well as interest under paragraph 8 of the Protocol).

Paragraph 4 provides that no business profits will be attributed to a permanent establishment because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent

establishment that performs more than one function for the enterprise, including purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's manufacturing operation and sell the manufactured output. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable with respect to its purchasing activities. If the sole activity were the purchasing of goods or merchandise for the enterprise, the issue of the attribution of income would not arise, because under subparagraph 4(d) of Article 5 (Permanent Establishment) there would be no permanent establishment.

Paragraph 5 illustrates the meaning of the term "business profits", as used in this Article. It includes income from the rental of tangible movable (personal) property and income from furnishing the services of others. It does not include compensation for personal services of individuals, whether self-employed or as employees. The definition also includes income from agriculture and forestry, which is taxable under Article 9 (Income from Real Property). Under Article 9, such income may be taxed in the country where the land is located; the land itself, in effect, constitutes a permanent establishment. However, the income may be taxed on a net basis under paragraph 4, in which case the result will be the same as under Article 6 (Business Profits).

Paragraph 6 coordinates the provisions of this Article and other provisions of the Convention. Under paragraph 6, where business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will, except where they specifically provide to the contrary, take precedence over the provisions of Article 6. Thus, for example, the taxation of interest will be determined by the rules of Article 11 (Interest) except where, as provided in paragraph 3 of Article 11, the interest is attributable to a permanent establishment, in which case the provisions of Article 6 apply.

Article 7. ADJUSTMENTS TO INCOME IN CASES WHERE PERSONS PARTICIPATE, DIRECTLY OR INDIRECTLY, IN THE MANAGEMENT, CONTROL OR CAPITAL OF OTHER PERSONS

This Article provides that when two related persons that are resident of the two Contracting States engage in transactions that are not at arm's length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such persons to reflect the income or tax with respect to such transactions that each would have had if the relationship between them had been at arm's length. The title of this Article was changed to make it easier to express in Russian.

Paragraph 1 deals with the circumstance where a resident of a Contracting State participates directly or indirectly in the management, control, or capital of a resident of the other Contracting State, or when the same persons participate directly or indirectly in the management, control, or capital of a resident of one of the Contracting States and any other person. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable.
If in either case transactions are entered into that are not at arm's length, the competent authorities may adjust the income of their residents to reflect what it would have been if they had been independent of each other.

Paragraph 2 provides that, where a Contracting State has made an adjustment that is consistent with the provisions of paragraph 1, the other Contracting State will make a corresponding adjustment to the tax liability of the related person in that other State. Paragraph 2 of Article 24 (Mutual Agreement Procedure) explains that the corresponding adjustment will not be prevented by a domestic statute of limitations. It is understood that the other Contracting State need adjust its tax only if it agrees that the initial adjustment is appropriate. The other provisions of the Convention, where relevant, are to be taken into account. The competent authorities will consult, as necessary, in applying these provisions.

Paragraph 3 simply confirms that this Article does not restrict the provisions of either Contracting State's domestic law relating to adjustments between related persons. The reference in paragraph 1 to "income" for example, does not imply that adjustments may not relate to deductions, exemptions, credits, or other elements affecting the tax liability.

Article 8. INTERNATIONAL TRANSPORT

This Article provides the rules that govern the taxation of income from the operation of ships and aircraft in international traffic. "International traffic " is defined in subparagraph 1 f) of Article 3 (General Definitions). Such income, when derived by a resident of either Contracting State, may be taxed only by that State, the country of residence. If the other Contracting State is the country where the income arises, it must exempt the income from tax, even if it is attributable to a permanent establishment in that State.

Income from the rental of ships or planes on a full basis for use in international traffic is considered operating income and is covered under paragraph 1. Income from the bareboat leasing of ships or planes is also exempt from tax at source if the ships or aircraft are used in international traffic by the lessee. In such a case, it does not matter whether the lessor

carries on a business of operating ships or planes; the same rule applies to a leasing company. However, if the lessor is an operating company, and the income is incidental to income from such operations, the exemption extends also to income from the rental of ships or aircraft used in domestic traffic by the lessee. Income from the leasing or use of containers in international traffic is also exempt from tax at source under this Article, whether derived by an operating company or by a leasing company.

Paragraph 3 clarifies that the provisions of paragraphs 1 and 2 apply to income from participation in a pool, joint business, or international transportation agency. For example, if the Russian airline were to form a consortium with other national airlines, the Russian participant's share of the income derived from U.S. sources would be covered by this Article.

Article 9. INCOME FROM REAL PROPERTY

Paragraph 1 provides the standard income tax treaty rule that income derived by a resident of Contracting State from real property, including income from agriculture or forestry, located in the other Contracting State may be taxed in that other State. The income may also be taxed in the state of residence.

Paragraph 2 defines real property in accordance with the laws of the Contracting States, but provides that it includes, in any case, any interest in land, unsevered products of land, and structures on the land, and excludes boats, ships, and planes.

Paragraph 3 clarifies that the Article covers income from any use of real property, without regard to the form of exploitation.

Paragraph 4 provides for a binding election by the taxpayer to be taxed on a net basis. The election is based on the U.S. Model provision, which reflects U.S. law. Since this Article provides for net basis taxation, it generally provides the same tax result as Article 6 (Business Profits). (Income from agricultural activities is referred to in both Articles.)

Article 10. DIVIDENDS

This Article provides rules for limiting the taxation at source of dividends paid by a company that is a resident of one Contracting State to a shareholder who is a resident of the other Contracting State. It also provides rules for the imposition of a tax at source on branch profits, analogous to the tax on dividends paid by a subsidiary company.

Paragraph 1 preserves the residence State's general right to tax its residents on dividends paid by a company that is a resident

of the other Contracting State. The same result is achieved by the saving clause of paragraph 3 of Article 1 (General Scope).

Except as otherwise provided in paragraph 4 and in paragraph 2 of the Protocol (discussed below), paragraph 2 limits to 5 percent the tax imposed by the source State on dividends paid to a resident of the other State when the beneficial owner is a company that owns at least 10 percent of the voting stock of the paying corporation (or 10 percent of the statutory capital of a Russian company if it does not have voting stock). In other cases, the source State tax is limited to 10 percent of dividends beneficially owned by residents of the other State. The limitation of the tax at source on portfolio dividends to 10 percent is not the preferred U.S. position (which is 15 percent in such cases). It was considered acceptable here as part of the negotiated package of withholding rates and in light of the negligible revenue consequences.

Paragraph 3 defines the term "dividends" as used in this Article. The term encompasses income from any shares or rights that are not debt claims and that participate in profits, plus income from other corporate rights treated for domestic law tax purposes as dividends in the country of residence of the distributing company, and income from other arrangements, even if debt claims, if such arrangements carry the right to participate in profits and the income is characterized as a dividend under the domestic law of the country of residence of the distributing company. The last case takes into account domestic law distinctions between debt and equity. The definition also confirms that distributions by a Russian joint venture to the foreign participants are dividends for purposes of this Article. Thus, such distributions are eligible for the reduced tax rates specified in paragraph 2.

Paragraph 4 explains that, where dividends are attributable to a permanent establishment or fixed base that the beneficial owner maintains in the other State, they are not subject to the provisions of paragraphs 1 and 2 of this Article, but are covered by Article 6 (Business Profits) or Article 13 (Independent Personal Services), as appropriate. This is also the case if the permanent establishment or fixed base has ceased to exist when the dividends are received as long as the dividends were attributable to the permanent establishment or fixed base in the earlier year.

Paragraph 5 permits a Contracting State to impose a branch profits tax on a corporation that is a resident of the other State. The tax is in addition to the ordinary tax on business profits. The additional tax is imposed on the "dividend equivalent amount" of such profits at the 5 percent rate that would apply to dividends paid by a wholly-owned subsidiary corporation to its parent. At present Russia does not impose such a tax. The U.S. tax will be imposed in accordance with section 884 of the Internal Revenue

Code, or a successor statute, subject to the reduced rate provided for in this Article. Paragraph 2 of the Protocol explains the meaning of the term "dividend equivalent amount".

Paragraph 2 of the Protocol also relaxes the limitations on source country taxation for dividends paid by a U.S. Regulated Investment Company (RIC) and a Real Estate Investment Trust (REIT). A dividend paid by a RIC is subject to the 10-percent portfolio dividend rate regardless of the percentage of voting shares of the RIC held by the recipient of the dividend. The 5-percent rate is intended to relieve multiple levels of corporate taxation. Since RICs do not pay corporate tax with respect to amounts distributed, the only tax imposed on their distributions is the shareholder-level tax. Moreover, a foreign shareholder could own a 10 percent interest in a RIC without owning a 10 percent interest in the companies whose shares are held by the RIC. In the case of a dividend paid by a REIT, the domestic law rate applies, i.e. 30 percent in the case of the United States. In some other recent U.S. treaties, the tax on REIT dividends is limited to the 15-percent portfolio dividend rate for certain individual shareholders presumed to be in the lowest bracket of the U.S. individual income tax. In this case, because the portfolio rate is only 10 percent, below the lowest U.S. individual tax bracket, the single statutory rate of 30 percent will apply to all REIT dividends. Little such investment by Russian individuals is anticipated in the near future.

Article 11. INTEREST

Paragraph 1 grants to each Contracting State the exclusive right (subject to paragraph 3) to tax interest derived and beneficially owned by its residents, without regard to source. Each Contracting State agrees to exempt from tax interest derived and beneficially owned by residents of the other State.

Paragraph 2 defines the term "interest" as used in the Convention to include income from debt claims of every kind other than those giving rise to dividends under paragraph 3 of Article 10 (Dividends), as well as income treated as interest by the taxation law of the source State. In particular, income from government securities, income from bonds or debentures, and any premiums or prizes attaching to such securities, bonds or debentures are considered interest. Interest on bank deposits and on loans secured by mortgages is also covered. The definition does not refer to penalties and fines for late payment, which are frequently explicitly excluded from the treaty definition of interest. Such amounts may be imposed in accordance with domestic law, but would be exempt from tax at source under Article 19 (Other Income).

Paragraph 3 provides an exception from the rule of paragraph 1 in cases where the beneficial owner of the interest, a resident

of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed based situated in that other State and the interest is attributable to that permanent establishment or fixed base. In such a case, the income is taxable to the permanent establishment or fixed base in accordance with the provisions of Article 6 (Business Profits) or Article 13 (Independent Personal Services). This rule applies even if the permanent establishment or fixed base no longer exists when the interest is received or accrued, as long as the interest would be attributable to the permanent establishment or fixed base if it had been paid or accrued in the earlier year.

Paragraph 4 provides that, if as a result of a special relationship between persons the interest paid is excessive, Article 11 applies only to the amount of interest payments that would have been made absent such special relationship (i.e., an arm's length interest payment). Any excess amount of interest paid remains taxable according to the domestic law of the source State, with due regard to the other provisions of the Convention. Thus, for example, if the excess amount would be treated as a distribution of profits, such amount could be taxed as a dividend rather than as interest, but the tax would be subject, if appropriate, to the rate limitations of paragraph 2 of Article 10 (Dividends).

Paragraph 3 of the Protocol reserves the right of the United States to tax an excess inclusion of a residual holder of a Real Estate Mortgage Investment Conduit (REMIC) in accordance with its law; thus, the tax on such an excess inclusion of a resident of Russia would be subject to the domestic rate of withholding tax, now 30 percent.

Because the rule of paragraph 2 provides for exemption at source of interest derived by a resident of the other Contracting State, the United States will not impose its tax on excess interest of a U.S. branch of a Russian company (Code section 884(F)(1)(B)).

Article 12. ROYALTIES

Paragraph 1 grants to each Contracting State the exclusive right (subject to paragraph 3) to tax royalties derived and beneficially owned by its residents, without regard to source. Each State agrees to exempt from tax royalties derived and beneficially owned by residents of the other State.

Paragraph 2 defines the term "royalties" as used in the Convention to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including computer software programs, video cassettes, and films and tapes for radio and

television broadcasting. It also includes payments for the use of, or right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property; or for information concerning industrial, commercial, or scien-tific experience. This definition does not refer to gain from the alienation of any right or property that is contingent on the productivity, use, or disposition of the property. However, the taxation of such gain is covered by Article 19 (Other Income), which provides for the same result. Income from the leasing of tangible personal property is taxed under Article 6 (Business Profits).

Paragraph 3 provides an exception to the rule of paragraph 1 in cases where the beneficial owner of the royalties, a resident of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base in that other State and the royalties are attributable to that permanent establishment or fixed base. In such a case, the royalties are taxable to the permanent establishment or fixed base in accordance with the provisions of Article 6 (Business Profits) or Article 13 (Independent Personal Services). The same rule applies if the permanent establishment or fixed base has ceased to exist when the royalties are received, so long as the royalties were attributable to it in the earlier year.

Paragraph 4 provides that, if as a result of a special relationship between persons, the royalty paid is excessive, Article 12 applies only to the amount of royalty payments that would have been made absent such special relationship (i.e., an arm's length royalty payment). Any excess amount of royalties paid remains taxable according to the laws of the United States and Russia, respectively, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of profits, such excess amount could be taxed as a dividend rather than as a royalty payment, but the tax imposed on the dividend payment will be subject, if appropriate, to the rate limitations of paragraph 2 of Article 10 (Dividends).

Article 13. INDEPENDENT PERSONAL SERVICES

The taxation of capital gains, typically dealt with in Article 13, is in this case addressed in Article 19 (Other Income).

The Convention deals in separate articles with different classes of income from personal services. Article 13 deals with the general class of income from independent personal services, and Article 14 deals with the general class of income from employment (dependent personal services). Articles 15 through 18 provide exceptions and additions to these general rules for directors' fees (Article 15); government service salaries and pensions (Article

16); pensions in respect of personal service income and social security benefits (Article 17); and certain income of students, trainees and researchers (Article 18).

Unlike the U.S. and OECD Models, this Convention does not provide a separate article dealing with entertainers and athletes. Like the U.S. and OECD Models, the Convention does not provide a separate rule for the remuneration of teachers. (See the discussion under Article 18 (Students, Trainees, and Researchers.)) The compensation of such individuals is taxable under this Article or Article 14 (Income from Employment).

Income derived by an individual who is a resident of one Contracting State from the performance of personal services in an independent capacity in the other Contracting State is exempt from tax in that other State unless three conditions are satisfied. The income may be taxed in that other State if the services are or were performed there (see Code section 864(c)(6)); the income is attributable to a fixed base that is or was regularly available to the individual in that other State for the purpose of performing his services; and the individual remained in that other State for more than an aggregate of 183 days in the calendar year during which the services were performed. If those three conditions are met, the income attributable to the fixed base also may be taxed by the State where the fixed base is located. The income attributed to the fixed base must be taxed on a net basis, after allowance of deductions for business expenses, in accordance with principles similar to those provided in Article 6 (Business Profits) for the taxation of business enterprises. However, in this case, only income from services performed in a Contracting State may be attributed to a fixed base in that State. The additional requirement in this Article, that the State in which the services are performed may not tax unless the individual performing the services is or was present for more than 183 days during the calendar year, is not found in the U.S. or OECD Models. It was carried over from the 1973 Convention.

Paragraph 2 notes that the term "independent personal services" includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list, which is derived from the OECD Model, is not exhaustive. The term includes all personal services performed by an individual for his own account, where he receives the income and bears the risk of loss arising from the services.

Paragraph 4 of the Protocol acknowledges that the State of source may require a preliminary withholding of tax from income derived by residents of the other State, including but not limited to income referred to in this Article. Where there is a tentative withholding of tax, each State agrees to make timely refunds on

application of the taxpayer if the Convention provides for a reduced rate or an exemption.

Article 14. DEPENDENT PERSONAL SERVICES

This Article deals with the taxation of remuneration derived by a resident of a Contracting State for the performance of personal services in the other Contracting State as an employee.

Under paragraph 1, remuneration derived by an employee who is a resident of a Contracting State may be taxed by his State of residence. This is the same result as achieved by paragraph 3 of Article 1 (General Scope). However, to the extent that the remuneration is derived from an employment exercised (the performance of services) in the other Contracting State, the remuneration also may be taxed by the other Contracting State if the conditions specified in paragraph 2 are satisfied.

Paragraph 1 also provides that the more specific rules of Articles 15 (Directors' Fees), 16 (Government Service), and 17 (Pensions), apply in the case of employment income described in one of these articles. Thus, even though the State of source has a right to tax employment income generally under Article 14, it may not have the right to tax a particular type of income under the Convention if that right is proscribed by one of the aforementioned articles.

Under paragraph 2, the Contracting State in which the services are performed may also tax the remuneration unless three conditions are satisfied: (1) the individual is present in that State for a period or periods not exceeding 183 days in the calendar year; (2) the remuneration is paid by, or on behalf of an employee who is not a resident of that Contracting State; and (3) the remuneration is not borne as a deductible (or capitalizable) expense by a permanent establishment or fixed base that the employer has in that State. If a foreign employer pays the salary of an employee, but a host country corporation or permanent establishment reimburses the foreign employer in a deductible payment that can be identified as a reimbursement, neither condition (2) nor (3), as the case may be, will be considered to have been fulfilled. Conditions (2) and (3) are intended to ensure that a Contracting State will not be required both to allow a deduction to the payor for the amount paid and to exempt the employee on the amount received. In order for the remuneration to be exempt from tax in the source State, all three conditions must be satisfied.

Paragraph 3 contains special rules that provide for exemption from tax at source in three specific cases. The first applies to remuneration for services performed as an employee aboard a ship or aircraft operated in international traffic. This rule is similar to the corresponding provision in the U.S. Model.

The other two cases are not found in the U.S. Model. One provides an exemption at source for employees remaining in the source State for not more than 12 consecutive months and employed at a construction site, assembly or installation project, or drilling operation that does not constitute a permanent establishment under the provisions of Article 5 (Permanent Establishment). Article 5 provides an 18-month threshold in the case of a construction site, assembly or installation project, or drilling operation. It was therefore considered appropriate to extend the threshold for individuals working at such locations beyond the 183 days provided in paragraph 2 of this Article. Russia was not willing to provide the same 18-month threshold for employees as for the company due to revenue concerns. The compromise position was to permit the taxation at source of employees who stay longer than 12 months. Paragraph 5 of the Protocol provides that temporary absences of less than one month are disregarded in counting the 12 consecutive months and clarifies that the employment may take place at more than one site.

The third case provides an exemption at source for individuals providing technical services under a contract that also grants the use of a right or property giving rise to a royalty payment under paragraph 2 of Article 12 (Royalties). The intended benefit of this rule is to exempt individuals providing such services, even though their remuneration may be borne by a local company or permanent establishment as part of the overall contract. Thus, for example, a technician sent to train the users of a licensed process would not be subject to tax on his remuneration for those services. This is consistent with the exemption from tax of the royalty payment under Article 12 (Royalties).

Article 15. DIRECTORS' FEES

This Article provides that a Contracting State may tax the fees paid by a company which is a resident of that State for services performed by a resident of the other Contracting State in his capacity as a director of the company. This rule is found in the OECD Model. It represents a departure from the U.S. Model, which treats such fees as remuneration for personal services under the article dealing with independent personal services or dependent personal services, as the case may be. The concession of source basis taxation by Russia of such fees is not expected to have much practical impact in the near future.

Article 16. GOVERNMENT SERVICE

This Article follows the corresponding provisions of the OECD Model.

Paragraph 1 provides that generally payments from the public funds of a Contracting State or political subdivision (republic, in the case of Russia) or local authority to compensate an individual for performing governmental services may be taxed only by that State. However, if the individual is either a citizen of the other State, or was a resident of the other State prior to taking the governmental job (or otherwise did not become a resident of the other State solely for the purpose of taking the job), the compensation may be taxed only by that other State. It is understood that a governmental worker's spouse who takes a governmental job subsequent to becoming a resident of the host state, nevertheless will be considered to have become a resident of the host State solely for the purpose of taking a governmental job.

Paragraph 2 provides rules for the taxation of pensions paid from public funds in respect of governmental services. Such pensions may be taxed only by the paying State unless the individual is a resident and citizen of the other State, in which case only the other (residence) State may tax the pension. This rule does not apply to social security benefits and other public pensions which are not in respect of services rendered to the paying government or a political subdivision or local authority thereof; such amounts are taxed under Article 17. However, this rule does apply to social security payments to U.S. Government employees for whom the social security system is the retirement plan related to their government service; i.e., in the unusual case where a Russian citizen and resident derives a pension for U.S. Government employment that is paid under the social security system, only Russia may tax that pension. This could happen, for example, if a locally hired driver for the U.S. Embassy in Moscow were to retire and receive a U.S. pension under social security.

The rules of paragraphs 1 and 2 are an exception to the saving clause of paragraph 3 of Article 1 (General Scope) for individuals who are neither citizens nor permanent residents of the State where the services are performed. Thus, for example, payments by Russia to its employees at the Russian Embassy in Washington are exempt from U.S. tax if the employees are not U.S. citizens or green card holders and were not residents of the United States at the time they became employed by Russia, even if they would otherwise be considered U.S. residents for tax purposes. (Under the 1984 modification to the definition of a U.S. resident in Code section 7701, this exception to the saving clause is of less relevance, since time spent in the United States as a foreign government employee does not count in applying the physical presence test of residence.)

Paragraph 3 provides that this article applies only to remuneration and pensions paid in respect of services of a governmental nature. Remuneration and pensions paid in respect of services for a government-conducted business (for example, a government-operated airline) are covered by Articles 13 (Independent Personal Services), 14 (Income from Employment) or 17 (Pensions), as appropriate.

Article 17. PENSIONS

Except as provided in Article 16 (Government Service), pensions and similar remuneration in consideration of past employment may be taxed only by the Contracting State of which the beneficial owner is a resident. It is understood that the services need not have been performed by the beneficial owner of the pension; for example, a pension paid to a surviving spouse who is a resident of Russia would be exempt from tax by the United States on the same basis as if the right to the pension had been earned directly by the surviving spouse. A pension may be paid in installments or in a lump sum.

Except as provided in Article 16 (Government Service), social security benefits and other public pensions paid by a Contracting State may be taxed only by that State. This rule is also an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a Russian social security benefit will be exempt from U.S. tax even if the beneficiary is a U.S. resident or a U.S. citizen (whether resident in the United States, Russia, or a third country).

The U.S. Model also provides rules concerning the taxation of annuities, alimony and child support. Since these items of income are not dealt with elsewhere in the Convention they are taxable under Article 19 (Other Income). Under that Article these items of income are taxable exclusively in the State of residence. Accordingly, the Convention provides the same tax treatment for these items of income as the U.S. model.

Article 18. STUDENTS, TRAINEES AND RESEARCHERS

This Article deals with visiting students, trainees, and, researchers. An individual who is a resident of one of the Contracting States and who visits the other Contracting State for the primary purpose of studying at an accredited educational institution, such as a university, or of studying or doing research as the recipient of a grant or similar payment from a charitable organization, or of acquiring training for a profession, will not be taxed by that other State on amounts received from abroad to cover his expenses and on any grant or similar payment regardless of its source.

The reference to "primary purpose" is meant to describe individuals participating in a full-time program of study, training, or research. It was substituted for the reference in the OECD Model to "exclusive purpose" to prevent too narrow an interpretation; it is not the intention to exclude full-time students who, in accordance with their visas, may hold part-time employment jobs. For U.S. purposes, a religious, charitable etc. organization as described in paragraph 1(c) means an organization that qualifies as tax-exempt under section 501(c)(3).

The exemptions provided in paragraph 1 are available for the period of time ordinarily necessary to complete the study, training, or research but not for more than five years in the case of training or research. It is expected that in most cases study programs would also be completed within five years; however, an individual who completes both undergraduate and graduate degrees could require a longer period.

For the exemption to apply to a researcher, the research must be undertaken in the public interest, and not primarily for the private benefit of a specific person or persons. For example, the exemption would not apply to a grant from a tax-exempt research organization to search for the cure to a disease if the results of the research become the property of a for-profit company. The exemption would not be denied, however, if the tax-exempt organization licensed the results of the research to a for-profit enterprise in consideration of an arm's-length royalty consistent with its tax-exempt status.

This Article is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a Russian student, trainee, or researcher is entitled to the benefits of this Article even if such individual becomes a resident of the United States under the substantial presence test of Code section 7701(b). However, the benefits of this Article are not available to a U.S. citizen or green card holder.

Article 19. OTHER INCOME

This Article provides the rules for the taxation of items of income not dealt with in the other articles of the Convention, such as alimony, child support payments, lottery winnings, punitive damages, cancellation of indebtedness income, and capital gains on assets other than real estate. (See paragraph 3 for real estate gains.)

Paragraph 1 contains the general rule that items of income derived by a resident of a Contracting State and not dealt with elsewhere in the Convention may be taxed only in the State of

residence. This exclusive right of taxation applies irrespective of the source of the income.

Paragraph 2 contains an exception to the general rule of paragraph 1 for income that is attributable to a permanent establishment or fixed base that is or was maintained in a Contracting State by a resident of the other Contracting State. The taxation of such income is governed by the provisions of Articles 6 (Business Profits) or 13 (Independent Personal Services). For example, other income, wherever arising, that is attributable to a permanent establishment that is or was maintained in the United States by a resident of Russia would be taxable by the United States.

Paragraph 3 provides a further exception to the rule in paragraph 1 of exclusive taxation at residence. Gains from the alienation of real property located in a Contracting State or of any right to share in the profits of a company whose assets consist at least 50 percent of real property located in a Contracting State may be taxed by that State. This provision preserves the U.S. right to apply its tax on foreign investment in real property. Point 6 of the Protocol provides that the United States retains the right to tax a U.S. "real property interest" and an interest in a partnership, estate, or trust to the extent such interest is attributable to a U.S. "real property interest."

Article 20. LIMITATION ON BENEFITS

Article 20 ensures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State -- and are not extended to residents of third States not having a substantial presence in, or business nexus with, the other Contracting State. For example, a resident of a third State might establish an entity resident in a Contracting State for the purpose of deriving income from the other Contracting State and claiming source State benefits with respect to that income. Absent Article 20, the entity would generally be entitled to benefits as a resident of a Contracting State, subject to any limitations imposed by the domestic law of the source State, (e.g., business purpose, substance-over-form, step transaction or conduit principles).

Article 20 follows the form used in other recent U.S. income tax treaties. See, e.g., the Convention between the United State of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes. The structure of the Article is as follows: Paragraph 1 lists a series of attributes of a resident of a Contracting State, the presence of any one of which will entitle that person to benefits of the Convention in the other Contracting State. Paragraph 2 provides

that benefits also may be granted to a person not entitled to benefits under the tests of paragraph 1, if the competent authority of the source State determines that it is appropriate to provide benefits in that case. Paragraph 3 defines the term "gross income" as used in paragraph 1(e)(ii). Point 7 of the Protocol defines the term "officially recognized securities exchange" as used in paragraph 1(c) as that term applies to the United States. At the time the Convention was signed there was not yet a corresponding definition for the Russian securities exchange, which was then being developed.

The first category of persons eligible for benefits from the other Contracting State under paragraph 1 consists of individual residents of a Contracting State. It is unlikely that individuals can be used to derive treaty-benefitted income on behalf of a third-country resident. If such an individual is receiving income as a nominee on behalf of a third country resident, benefits will be denied under the respective articles of the Convention by the requirement that the beneficial owner of the income be a resident of a Contracting State.

The second category consists of active businesses that are residents of one of the Contracting States and derive income from the other Contracting State that is connected with, or incidental to, that business. For this purpose, the business of making or managing investments is not considered an active business unless carried on by a bank or insurance company. The first six examples in the Memorandum of Understanding regarding the scope of the Limitations on Benefits Article in the Convention Between the Federal Republic of Germany and the United States of America (German Convention) illustrate the situations covered by subparagraph (b).

The third category consists of companies whose shares are regularly traded in substantial volume on an officially recognized securities exchange, or a company wholly owned, directly or indirectly, by a company that is a resident of the same State and whose shares are so traded.

The fourth category covers tax-exempt organizations, if more than half of the beneficiaries, members, or participants, if any, are individual residents of either Contracting State or persons who meet the criteria of subparagraph (b), (c), or (e) of this Article.

The fifth category provides a two part test, the so-called ownership and base erosion tests. Both must be satisfied for the resident to be entitled to benefits under subparagraph (e). The ownership test requires that more than 50 percent of the beneficial interest in the person (or, in the case of a corporation, more than 50 percent of each class of its shares) be owned, directly or indirectly, by persons who are themselves entitled to benefits under the other tests of paragraph 1 (other than subparagraph (b)).

The base erosion test requires that not more than 50 percent of the person's gross income be used, directly or indirectly, to meet liabilities to persons other than persons eligible for benefits under the other tests of paragraph 1 (other than subparagraph (b)). For this purpose "gross income" means gross receipts or, in the case of a manufacturing or producing activity, gross receipts less the direct costs of labor and materials. (See paragraph 3.)

The rationale for this two-part test is that, to prevent such benefits from inuring substantially to third-country residents, it is not sufficient to require substantial ownership of the equity of the entity by treaty country residents. It is also necessary to ensure that the entity's tax base not be eroded by deductible payments to third country residents.

It is intended that the provisions of paragraph 1 will be self executing. Unlike the provisions of paragraph 2, discussed below, claiming benefits under paragraph 1 does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the tax-payer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

It is understood that just as the two Contracting States and their political subdivisions are to be treated as residents of those States for purposes of Convention benefits, they also are entitled to benefits under Article 20.

Paragraph 2 permits the competent authority of the State in which income arises to grant Convention benefits in additional cases, even if the beneficial owner of the income does not meet the safe harbor standards of paragraph 1 (or the information is not available to make such a determination). This discretionary provision is included in recognition that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a Contracting State is warranted by sound business practice and does not indicate a motive of attempting to derive unintended Convention benefits.

Paragraph 3 defines the term "gross income" as used in paragraph 1(e)(ii).

Article 21. CAPITAL

This Article specifies the circumstances in which a Contracting State may impose tax on capital owned by a resident of the other Contracting State. Since neither the United States nor Russia imposes a national-level tax on capital, the purpose of this article is to provide rules to deal with any such tax subsequently enacted.

Paragraph 1 provides that capital represented by real property (as defined in Article 9 (Income from Real Property)) that is owned by a resident of one Contracting State but located in the other Contracting State may be taxed by that other State.

Paragraph 2 provides the same rule for movable property that is part of the business property of a permanent establishment or fixed base that a resident of one Contracting State maintains in the other Contracting State. Such capital may be taxed in that other State.

In both cases, paragraphs 1 and 2, the State of residence may also tax; the taxing right given to the State where the capital is located is not an exclusive right.

Paragraph 3 provides that capital represented by ships, aircraft or containers owned by a resident of one Contracting State and operated in international traffic may be taxed only in the residence State. This is consistent with the rule of Article 8 (International Transport), that addresses the income from international transportation activities.

Paragraph 4 provides the same rule as paragraph 3, taxation only in the country of residence of the owner, for all other items of capital.

Article 22. RELIEF FROM DOUBLE TAXATION

Each Contracting State uses the foreign tax credit method to avoid double taxation of income arising in the other State. The credit is subject to the limitations of domestic law, such as Code sections 56(a) and 904.

Paragraph 8 of the Protocol explains and modifies this Article. Subparagraph (a) of paragraph 8 provides that Russia will credit the U.S. tax imposed on U.S. citizens resident in Russia by reason of citizenship, subject only to the limitation to the amount of the Russian tax on non-Russian source income. This includes the portion of the tax imposed solely on the basis of citizenship in accordance with the saving clause of paragraph 3 of Article 1 (General Scope). Thus, the United States fully retains primary taxing jurisdiction over a U.S. citizen who is resident in the treaty partner. Accordingly, it is not necessary to re-source any of the U.S. source income of such an individual to avoid double taxation. (Cf. Paragraph 3 of Article 23 (Relief from Double Taxation) of the U.S.-German income tax convention.)

Paragraphs (b) and (c) of point 8 of the Protocol modify the Russian tax on profits and income referred to in Article 2 (Taxes Covered). The modified taxes constitute separate levies (i.e., are considered to be distinct from the Russian statutory taxes) for

purposes of determining their eligibility for the credit allowed under section 901. The Protocol's modifications (described below) are intended to make the levies taxes on net income that would satisfy the U.S. standards of a creditable foreign income tax. In light of the recent, rapid evolution of the Russian tax system and consistent with U.S. treaty policy, the Convention does not guarantee a credit for the separate levies.

At the time the Convention was signed, the base on which the Russian taxes covered in Article 2 were imposed was determined without a full deduction for labor costs and interest expense in the case of companies with Russian participation (either wholly owned by Russian residents or joint ventures with Russian participation). The deduction for aggregate wages paid was limited, in effect, to four times the minimum wage per worker, and generally interest expense was deductible only to the extent paid on bank loans of less than 12 months. Those limits have since been liberalized, but still would not be sufficient to recover the actual expenses of joint ventures with substantial U.S. participation. There also was a concern that the current law might be replaced by one further limiting, or totally disallowing, a deduction for labor costs. The Protocol's modifications remove both of those potential obstacles to creditability of the Russian tax.

Subparagraph (b) of paragraph 8 of the Protocol expands the allowable deductions for wages and interest expense of a joint venture that is a resident of Russia when U.S. residents own at least 30 percent of the beneficial interest in the venture and the venture's total corporate capital (i.e., equity capital owned by all participants determined without regard to country of residence) amounts to at least $100,000 (an "eligible U.S. venture"). An eligible venture may deduct its expenses for remuneration for personal services in determining its Russian tax base. The limitations on the deductibility of interest of an eligible venture are relaxed in two respects: Any domestic law restrictions on the lender or the term of the loan will not apply, and the deduction for interest on a particular loan may not be at a rate less than the London Inter-bank Offered Rate plus a reasonable risk premium, to be specified in the loan agreement.

Subparagraph (b) of paragraph 8 of the Protocol also provides that, if the Russian tax law currently in effect (or a substantially similar tax law) should be replaced by another law that either denies or limits the deduction of an eligible U.S. venture for interest expense or for labor costs, the venture may continue to determine its tax base as provided this in subparagraph. This provision was added to take into account the possible entry into force of a proposed "income" tax that would replace the "profits" tax and eliminate the deduction for labor costs in exchange for a lower tax rate. The Protocol requires consistency; in the event such a new tax is imposed, an eligible

venture electing to claim the deductions permitted under subparagraph (b) would have to continue to apply the rate of tax of the profits tax (not the lower rate of the income tax).

Paragraph (c) of point 8 of the Protocol extends to U.S. investors in Russia who are engaged in a banking, insurance or other financial business, either through a Russian permanent establishment or through an eligible U.S. venture the same modifications of the interest deduction and the deduction for labor remuneration as are provided in paragraph (b) for other eligible U.S. ventures. Businesses claiming the benefits of paragraph (c) must pay tax at the higher rates specified in the general law on taxation on profits (32%) rather than at the lower rates specified in the separate Russian tax laws applicable to banks (30%) and insurance companies (25%). Since the Russian banking and insurance taxes deny a deduction for wage expense and limit the interest deduction, it is anticipated that Russian tax on these businesses, as modified by the Protocol, will be less than the tax due under domestic law.

There was no need to provide a corresponding modification of Russian tax for U.S. companies operating in Russia through permanent establishments in areas other than banking and insurance. Like wholly foreign-owned joint ventures, permanent establishments of foreign companies are permitted a full deduction for labor costs. A full deduction for interest expense is provided by point 1(c) of the Protocol, subject to the same interest rate limitation described above. (See discussion of Article 6 (Business Profits).)

The Russian tax on dividends paid to U.S. shareholders (and not attributable to a permanent establishment or fixed base in Russia of the U.S. shareholders) is a separate levy for purposes of the U.S. foreign tax credit. If the profits tax, as modified by this treaty, qualifies as a net income tax under Code section 901, the withholding tax on dividends would be treated as a tax in lieu of that tax under Code section 903.

Article 23. NON-DISCRIMINATION

This Article ensures that citizens of a Contracting State, in the case of paragraph 1, and residents of a Contracting State, in the case of paragraphs 2 through 4, will not be subject to discriminatory taxation in the other Contracting State. For this purpose, non-discrimination means providing the better of national treatment or most-favored-nation treatment with respect to statutory rules and administrative practice; it does not require most-favored-nation treatment when citizens or residents of a third State are provided benefits under special agreements, such as bilateral income tax treaties with the third State. Thus, if Russian law imposes a more favorable tax regime on the income of joint ventures with a specified percentage of foreign capital vis-

a-vis companies wholly owned by residents, the benefits of the former regime will also apply to joint ventures in which the foreign participation is by U.S. citizens or residents. (Russian tax law now favors wholly foreign-owned companies over those with some local ownership. It does not discriminate among foreign owners. This provision confirms and guarantees that no such discrimination could exist that would adversely affect U.S. citizens or residents.)

Paragraph 1 provides that a citizen of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State that are different from or more burden-some than the taxes and connected requirements imposed upon a citizen of that other State or of a third State in the same circumstances. A citizen of a Contracting State is afforded protection under this paragraph even if the citizen is not a resident of either Contracting State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same tax treatment in Russia as a citizen of any other country who is a resident of that third country and in the same circumstances.

It is understood, however, that for U.S. tax purposes, a U.S. citizen who is resident outside the United States, whether in Russia or a third country, is not in the same circumstances as a citizen of Russia who is a resident outside the United States, because the U.S. citizen is subject to U.S. tax on his worldwide income and the Russian citizen is subject to U.S. tax on only his U.S. income. Thus, a citizen of Russia resident in a third state is not entitled under this Article to net-basis taxation at source of dividends paid by U.S. companies because a U.S. citizen resident in a third country is taxed on a net basis by the United States. Similarly, it is understood that neither Contracting State is required to grant to residents of the other Contracting State the same personal exemptions and deductions that it provides to its own residents to take account of marital status or family responsibilities.

Paragraph 2 of the Article provides that a permanent establishment in a Contracting State of a resident of the other Contracting State may not be less favorably taxed in the first-mentioned State than an enterprise of that first-mentioned State or of a third State that is carrying on the same activities. The latter, most-favored-nation, treatment does not extend to benefits granted to permanent establishments of residents of a third State in accordance with a special agreement with that third State, such as an income tax Convention.

Section 1446 of the Code imposes on any partnership, whether domestic or foreign, the obligation to withhold tax from a foreign partner's distributive share of income effectively connected with a U.S. trade or business. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a

refund. In the context of the Convention, this obligation applies with respect to a Russian resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners.

It is understood that this withholding provision is not a form of discrimination within the meaning of paragraph 2 of the Article, but merely a reasonable adaptation of the mode of taxation to the particular circumstances of nonresident partners. Like other withholding provisions applicable to nonresident aliens, this is a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it may otherwise be difficult for the United States to enforce its tax jurisdiction. Cf. the "backup withholding" rules of section 3406 which apply only to U.S. citizens and residents and serve a similar purpose. (The relationship between paragraph 2 and the imposition of the branch tax is dealt with below in the discussion of paragraph 5.)

Paragraph 3 prohibits discrimination in the allowance of deductions. When a resident of a Contracting State pays interest or royalties or makes other disbursements to a resident of the other Contracting State, the first-mentioned Contracting State must allow a deduction for those payments in computing the taxable profits of the enterprise under the same conditions as if the payment had been made to a resident of the first-mentioned State. An exception to this rule is provided for cases where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 4 of Article 11 (Interest) or paragraph 4 of Article 12 (Royalties) apply, because all of these provisions permit the denial of deductions in certain circumstances in respect to excess (not at arm's length) payments between related persons. Accordingly, paragraph 3 permits the denial or deferral of a deduction for interest in accordance with domestic thin capitalization rules such as section 163(j). The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons which includes the person incurring the expense.

Paragraph 3 also provides that any debts of a resident of a Contracting State to a resident of the other Contracting State are deductible in the first-mentioned Contracting State in computing taxable capital under the same conditions as if the debt had been contracted to a resident of the first-mentioned State. This Article also applies to taxes imposed by republics of Russia and to state and local taxes in the United States. (See discussion of paragraph 6.) Thus, for example, if a tax is imposed on the value of real property net of debt, the same deduction must be allowed

with respect to debt of creditors who are residents of either Contracting State.

Paragraph 4 requires that a Contracting State not impose other or more burdensome taxation or connected requirements on a company that is a resident of that State that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, than the taxation or connected requirements that it imposes on similar resident companies owned by residents of the first-mentioned State or of a third State. It is understood that the U.S. rules that impose tax on a liquidating distribution of a U.S. subsidiary of a Russian company and the rule restricting the use of small business corporations to U.S. citizens and resident alien share-holders do not violate the provisions of this Article. Similarly, it is understood that if Russia were to simplify the operation of the turnover tax applicable to foreign persons and joint ventures by consolidating the many rates applicable to local companies into a smaller group of rates without increasing the overall burden on foreign investors, that would not be contrary to paragraph 2 or 4 of this Article.

Paragraph 5 of the Article specifies that no provision of the Article will prevent either Contracting State from imposing the branch profits tax described in paragraph 5 of Article 10 (Dividends). At present Russia does not impose such a tax, but if it were to introduce one consistent with paragraph 5 of Article 10 it could do so under this Article.

Paragraph 6 provides that, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered), for purposes of providing nondiscrimination protection this Article applies to taxes of every kind and description. Although not explicitly so stated, this rule is intended to extend to taxes at all levels of government. The reference to taxes of political subdivisions was omitted largely for drafting reasons with respect to the Russian text. Customs duties are not considered to be taxes for this purpose.

The saving clause of paragraph 3 of Article 1 (General Scope) does not apply to this Article, by virtue of the exceptions in paragraph 4(a) of Article 1. Thus, for example, a U.S. citizen who is resident in Russia may claim benefits in the United States under this Article.

Article 24. MUTUAL AGREEMENT PROCEDURE

This Article provides for cooperation between the competent authorities of the Contracting States to resolve disputes that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention.

Paragraph 1 provides that where a person considers that the actions of one or both Contracting States will result for him in taxation that is not in accordance with the Convention he may present his case to the competent authority of his State of residence or citizenship. It is not necessary for a person first to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities. Also, the Convention does not limit the time during which a case may be brought.

Paragraph 2 provides that, if the competent authority of the Contracting State to which the case is presented considers the case to have merit, and if it cannot reach a unilateral solution, it will seek agreement with the competent authority of the other Contracting State to avoid taxation not in accordance with the Convention. If agreement is reached under this provision, it is to be implemented even if implementation would be otherwise barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, the Convention overrides time or other procedural limitations of domestic law only for the purpose of making refunds (not to impose additional tax).

Paragraph 3 authorizes the competent authorities to seek to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. The paragraph includes a non-exhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement. They may agree to the same attribution of income, deductions, credits or allowances between a resident of one Contracting State and its permanent establishment in the other, and to the allocation of income, deductions, credits or allowances between persons. These allocations are to be made in accordance with the arm's-length principles of Article 6 (Business Profits) and Article 7 (Adjustments to Income in Cases where Persons Participate, Directly or Indirectly, in the Management, Control or Capital of Other Persons). The competent authorities may also agree to settle a variety of conflicting applications of the Convention, including those regarding the characterization of items of income, the application of source rules to particular items of income, differences in meanings of a term, and differences in applying penalties, fines and interest. Agreements reached by the competent authorities under this paragraph need not conform to the internal law provisions of either Contracting State. The competent authorities also may address cases of double taxation not foreseen by the Convention and attempt to reach an agreement that would prevent that result.

Paragraph 4 authorizes the competent authorities to communicate with each other directly for these purposes. It is not necessary to communicate through diplomatic channels.

The benefits of this Article are also available to residents of either Contracting State. (See paragraph 4(a) of Article 1 (General Scope).)

Article 25. EXCHANGE OF INFORMATION

This Article provides for the exchange of information between the competent authorities of the Contracting States. The information to be exchanged is that necessary for carrying out the provisions of the Convention or the domestic laws of the United States or Russia concerning the taxes covered by the Convention. For the purposes of this Article, the taxes covered by the Convention include all taxes imposed at the national level. Exchange of information with respect to domestic law is authorized insofar as the taxation under those domestic laws is not contrary to the Convention. Thus, for example, information may be exchanged with respect to any national level tax, even if the transaction to which the information relates is a purely domestic transaction in the requesting State.

Paragraph 1 states that information exchange is not restricted by Article 1 (General Scope). This means that information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For example, if a third-country resident has a permanent establishment in Russia that engages in transactions with a U.S. resident, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Such information would not be routinely exchanged, but may be requested in specific cases.

Paragraph 1 also provides assurances that any information received in accordance with this Article will be treated as secret, subject to the same restrictions on disclosure that apply to information obtained under the laws of the requesting State. Information received may be disclosed only to persons, including courts and administrative bodies, concerned with the assessment, collection, enforcement or prosecution in respect of the taxes to which the information relates, or to persons concerned with the administration of these taxes. The information must be used by such persons in connection with these designated functions. Persons concerned with the administration of taxes, in the United States, include the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies is for use in the performance of their role in overseeing the administration of U.S. tax laws. Information received under this Article may be disclosed in public court proceedings or in judicial decisions.

Paragraph 2 explains that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures that are at variance

with the laws or administrative practice of either State. Nor is either State obligated to supply information not obtainable under the laws or administrative practice of either State. Thus, there is no obligation to furnish information to the other Contracting State if either the requested State or the requesting State could not obtain such information for itself in a domestic case. There is also no obligation to disclose trade secrets or other information, the disclosure of which would be contrary to public policy. Either Contracting State may, however, at its discretion, subject to the limitations of the paragraph and its internal law, provide information that it is not obligated to provide under the provisions of this paragraph.

Paragraph 3 provides that, when information is requested by a Contracting State in accordance with this Article, the other Contracting State is obligated to obtain the requested information as if the tax in question were the tax of the requested State, even if that State has no direct tax interest in the case to which the request relates. The paragraph further provides that the requesting State may specify the form in which information is to be provided (e.g., depositions of witnesses and authenticated copies of original documents), so that the information can be used in the judicial proceedings of the requesting State. The requested State should provide the information in the form requested to the same extent that it can obtain information in that form under its own laws and administrative practices with respect to its own taxes.

Article 26. MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR OFFICERS

This Article confirms that any fiscal privileges to which members of diplomatic or consular missions are entitled under the general provisions of international law or under special agreements will apply, notwithstanding any provisions of this Convention. The language of the U.S. Model was modified to make it clear that this rule protects the fiscal privileges of technical staff and other employees of such missions as well as those with diplomatic status.

Article 27. ENTRY INTO FORCE

This Article provides the rules for bringing the Convention into force and giving effect to its provisions. Paragraph 1 provides for the ratification of the Convention by both Contracting States and the prompt exchange of instruments of ratification.

Paragraph 2 provides that the Convention will enter into force on the date on which instruments of ratification are exchanged. The Convention will have effect with respect to taxes withheld at source on dividends, interest and royalties for amounts paid or credited on or after the first day of the second month following the month in which the Convention enters into force. For example,

if the Convention were to enter into force on November 10, 1993, the withholding rates on dividends, interest and royalties would be reduced (or eliminated) for amounts paid on or after January 1, 1994. For all other income taxes, the Convention will have effect for any taxable period beginning on or after January 1 of the year following entry into force.

The 1973 Convention will cease to have effect when the provisions of this Convention take effect in accordance with paragraph 2. Although paragraph 3 refers to the entry into force of this Convention, it was the intention of the negotiators that the provisions of the 1973 Convention should continue to apply until the corresponding provisions of this Convention take effect. A similar intent is stated explicitly in paragraph 4, which provides that a person entitled to the benefits of the Convention may elect to continue to apply that Convention for the first taxable year in which this Convention would otherwise have effect. This is a taxpayer-by-taxpayer election. This provision is not relevant to the withholding taxes on dividends, interest, and royalties, which are at least as favorable under this Convention as under the 1973 Convention. It can be relevant, however, to a teacher or journalist who may be entitled under the 1973 Convention, but not under this Convention, to a special exemption from tax in the host country with respect to the individual's remuneration for those services. In such a case, the individual could elect to apply all of the 1973 Convention for the first taxable year, but he could not choose, for example, to apply the 1973 Convention with respect to personal service income and this Convention with respect to dividend income.

Article 28. TERMINATION

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of this Article. A Contracting State may terminate the Convention at any time after 5 years from the date of its entry into force by giving written notice through diplomatic channels to the other Contracting State at least six months in advance. If such notice is given, the Convention will cease to apply in respect of taxes withheld on dividends, interest and royalties paid or credited on or after the first of January following the six month period and with respect to other taxes for taxable periods beginning on or after the first of January following the six month period. Thus, for example, if notice of termination is given in July or later of a calendar year, the termination will not be effective as of the following January 1 but as of the second January 1, since the notice period must continue for at least six months.

Article 28 relates to unilateral termination by a Contracting State of the Convention. The Article does not prevent the

Contracting States from entering into a new bilateral agreement that supersedes, amends or terminates provisions of the Convention either prior to the expiration of the five year period or without the six month notification period.

PROTOCOL

The provisions of the Protocol are an integral part of the Convention. Each has been described in the discussion of the Article to which it refers.

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE UNITED STATES OF AMERICA AND THE CZECH REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL SIGNED AT PRAGUE ON SEPTEMBER 16, 1993

This is a technical explanation of the Convention between the United States and the Czech Republic signed on September 16, 1993 ("the Convention"). The Convention is based on the U.S. Treasury Department's draft Model Income Tax Convention, published on June 16, 1981 ("the U.S. Model"), the Model Tax Convention on Income and Capital published by the OECD in 1992 ("the OECD Model"), and other more recent U.S. income tax conventions. Although the U.S. Model has been withdrawn, and a new Model is being developed as this Technical Explanation is being prepared, the U.S. Model was the relevant Model at the time the Convention was negotiated.

The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention.

Article 1. GENERAL SCOPE

Paragraph 1 provides that the Convention is applicable to residents of the United States or the Czech Republic, except where the terms of the Convention provide otherwise. Under Article 4 (Resident), a person is treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of his domicile or other similar criteria, subject to certain limitations. If a person is, under those criteria, a resident of both Contracting States, a single state of residence (or no state of residence) is assigned under Article 4. These rules govern for all purposes of the Convention. Certain provisions of the Convention are also applicable, however, to persons who may not be residents of either Contracting State. Examples include Articles 20 (Government Service), 25 (Non-Discrimination) and 27 (Exchange of Information and Administrative Assistance).

Paragraph 2 is the same as the corresponding provision in the U.S. Model. Under this paragraph, the Convention may not restrict any exclusion, exemption, deduction, credit or other benefit accorded by the tax laws of the Contracting States or by any other agreement between the Contracting States. In effect, paragraph 2 provides that the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under

domestic law. Thus, a right to tax granted by the Convention to a Contracting State cannot be exercised unless the domestic law of that State also provides for such a tax.

Under the principle of paragraph 2, a taxpayer's liability to U.S. tax need not be determined under the Convention if the Code would produce a more favorable result. This does not mean, however, that a taxpayer may pick and choose among Code and Convention provisions in an inconsistent manner in order to minimize tax. For example, suppose a Czech resident has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that earn taxable income under the Code but do not meet the permanent establishment threshold tests of the Convention. One trade or business is profitable, and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be taxable and the loss would be offset against the profits of the two profitable ventures. In this situation, the taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B.10.) If the taxpayer invokes the Code for the taxation of all three ventures, however, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

Paragraph 3 contains the traditional "saving" clause found in all U.S. treaties. Under this paragraph, each of the Contracting States may tax its own residents, citizens and former citizens, in accordance with its domestic law, notwithstanding any Convention provision to the contrary. If, for example, a Czech resident performs independent personal services in the United States and the income from the services is not attributable to a fixed base in the United States, Article 14 (Independent Personal Services) would normally prevent the United States from taxing the income. If, however, the Czech resident is also a citizen of the United States, the "saving" clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under normal Code rules (i.e., without regard to Code section 894(a)). Special foreign tax credit rules applicable to U.S. taxation of certain U.S. income of U.S. citizens resident in the Czech Republic are provided in paragraph 3 of Article 24 (Relief from Double Taxation).

"Residence," for purposes of the "saving" clause of paragraph 3, is determined under Article 4 (Resident). Thus, for example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, e.g., a "green card" holder, and is also a

resident of the Czech Republic under Czech law, and the tie-breaker rules of Article 4 determine that he is a resident of the Czech Republic, then he will be entitled to U.S. benefits under the Convention.

Paragraph 3 also reserves the right of each Contracting State to tax certain former citizens. In the case of the United States, citizens whose loss of citizenship had as one of its principal purposes the avoidance of U.S. tax may be taxed for a period of ten years following the loss of citizenship in accordance with Code section 877.

Paragraph 4 lists several exceptions to the "saving" clause under which a Contracting State's benefits are extended to its citizens and residents. Under subparagraph a), U.S. residents and citizens are entitled to certain U.S. benefits provided under the Convention: specifically, the correlative adjustments authorized by paragraph 2 of Article 9 (Associated Enterprises); the exemption of social security benefits paid by the Czech Republic that is provided in paragraph 1(b) of Article 19 (Pensions, Annuities, Alimony, and Child Support); the exemption of nondeductible alimony and child support payments paid by a Czech resident that is provided in paragraph 4 of Article 19 (Pensions, Annuities, Alimony, and Child Support); the guarantee of a foreign tax credit provided in Article 24 (Relief from Double Taxation); the nondiscrimination protection of Article 25 (Non-Discrimination) and the competent authority procedures of Article 26 (Mutual Agreement Procedure).

Under subparagraph b), certain additional benefits are available to U.S. residents who are neither U.S. citizens nor "green card" holders (such as persons who are residents under the substantial presence test of Code section 7701(b)). These are the benefits extended to employees of the Czech Government under Article 20 (Government Service); to visiting students, trainees teachers and researchers under Article 21 (Students, Trainees, Teachers and Researchers); and to members of diplomatic and consular missions under Article 28 (Diplomatic Agents and Consular Officers).

Article 2. TAXES COVERED

This Article identifies the U.S. and Czech taxes to which all Articles of the Convention apply. Two articles of the Convention are also applicable, however, with respect to certain taxes other than those specified in Article 2. Article 25 (Non-discrimination) applies with respect to all taxes imposed at all levels of government, including state and local governments. Article 27 (Exchange of Information and Administrative Assistance) applies with respect to all taxes imposed by a Contracting State (i.e., imposed at the national level).

In the case of the United States, the Convention generally applies to the Federal income taxes imposed by the Internal Revenue Code. Except in the cases of Articles 25 (Non-discrimination) and 27 (Exchange of Information and Administrative Assistance), however, the accumulated earnings tax and personal holding company tax (which are considered penalty taxes) are excluded from coverage, as are the social security taxes provided in Code sections 1401, 3101 and 3111. The Convention applies to the excise taxes imposed with respect to the investment income of private foundations under Code sections 4940 et seq., but does not apply (except in the case of Articles 25 and 27) with respect to the excise taxes imposed on insurance premiums paid on policies issued by foreign insurers under Code section 4371.

In the case of the Czech Republic, the Convention generally applies to the income taxes imposed by the Czech income tax law and to the Czech tax on immovable property (the real property tax). As noted above, Article 25 (Non-Discrimination) applies to all taxes imposed at all levels of government in the Czech Republic and Article 27 (Exchange of Information and Administrative Assistance) applies to all national level taxes imposed by the Czech Republic.

Under paragraph 2, the Convention will apply to any taxes that are identical or substantially similar to those enumerated in paragraph 1 and that are imposed in addition to, or in place of, the existing taxes after September 16, 1993 (the date of signature of the Convention). Paragraph 2 also provides that the U.S. and Czech competent authorities will notify each other of significant changes in their taxation laws. This refers to changes that are of significance to the operation of the Convention. The competent authorities will also notify each other of official published materials concerning the application of the Convention. This refers to such materials as technical explanations, regulations, rulings and judicial decisions relating to the Convention.

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines a number of basic terms used in the Convention. Certain other terms are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Resident). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). The terms "dividends," "interest" and "royalties" are defined in Articles 10 (Dividends), 11 (Interest) and 12 (Royalties), respectively. The introductory language makes clear that the definitions specified in paragraph 1 apply for purposes of the Convention, and apply unless the context otherwise requires. The latter condition allows flexibility in interpretation of the treaty in order to avoid results not intended by the treaty's negotiators.

Subparagraph 1(a) defines the term "Contracting State" to mean the United States or the Czech Republic, depending on the context in which the term is used.

Subparagraph 1(b) defines the term "United States" to mean the United States of America. The term does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When used in a geographical sense, the "United States" includes the territorial sea and the seabed and subsoil of the adjacent area over which the United States may exercise rights in accordance with international law and in which U.S. tax law is in force. Currently, under Code section 638, U.S. tax law applies on the continental shelf only with respect to the exploration for and exploitation of mineral resources.

Subparagraph 1(c) defines the term "person" to include an individual, an estate, a trust, a partnership, a company and any other body of persons. This definition conforms to the definition in the U.S. Model. Any such person may be a "resident" of a Contracting State for purposes of Article 4 (Resident) and thus entitled to the benefits of the Convention.

Subparagraph 1(d) defines the term "company" as any body corporate or any entity treated as a body corporate for tax purposes. For U.S. tax purposes, the rules of Treas. Reg. §301.7701-2 generally will apply to determine whether an entity is a body corporate. Similarly, for U.S. tax purposes, a publicly traded partnership, as defined in Code section 7704, will be treated as a company for purposes of the Convention.

Subparagraph 1(e) defines the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" to mean an enterprise carried on by a resident of the appropriate Contracting State. Thus an enterprise of a Contracting State need not be carried on in that State. It may be carried on in the other State or in a third state.

Subparagraph 1(f) defines the term "international traffic" to mean any transport by a ship or aircraft, except when such transport is solely between places within a Contracting State. The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that the transport of goods or passengers solely between New York and Chicago by a Czech carrier (if permitted) would not be treated as international traffic, and the resulting income would not be exempt from U.S. tax under Article 8 (Shipping and Air Transport). The income would, however, be treated as business profits under Article 7 (Business Profits) and would therefore be taxable in the United States only if attributable to a U.S. permanent establishment and only on a net basis. If, however, goods or passengers are carried by a Czech airline from Prague to New York and then to Chicago, the entire trip would be international traffic. This would be true

even if a Czech carrier transferred goods at the U.S. port of entry from a ship or plane to a land vehicle, or if the overland portion of the trip in the United States were handled by an independent carrier under contract with the Czech carrier, so long as both parts of the trip were reflected in the original bill of lading.

Subparagraph 1(g) defines the term "competent authority." The competent authorities are charged with administering the provisions of the Convention and with attempting to resolve any doubts or difficulties that may arise in interpreting its provisions. The U.S. competent authority is the Secretary of the Treasury or his delegate. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who has, in turn, delegated the authority to the Assistant Commissioner (International). With respect to interpretive issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service. In the Czech Republic, the competent authority is the Minister of Finance or his authorized representative.

Paragraph 2 provides that, in the application of the Convention, any term used but not defined in the Convention will have the meaning that it has under the tax law of the Contracting State whose tax is being applied. If, however, the meaning of a term cannot be readily determined under the law of a Contracting State, or if there is a conflict in meaning under the laws of the two States that creates difficulties in the application of the Convention, the competent authorities may, pursuant to paragraph 3 of Article 26 (Mutual Agreement Procedure), agree to a common meaning in order to prevent double taxation or further any other purpose of the Convention. Likewise, if the definition of a term under either paragraph 1 of Article 3 or the tax law of a Contracting State would result in a circumstance unintended by the treaty negotiators or by the Contracting States (e.g., due to a change in the statutory definition of the term since the signing date of the Convention), the competent authorities may agree to a common meaning of the term. This common meaning need not conform to the meaning of the term under the laws of either Contracting State.

Article 4. RESIDENT

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. As a general matter, only residents of the Contracting States may claim the benefits of the Convention. The Convention definition of residence is to be used only for purposes of the Convention. The fact that a person is determined to be a resident of a Contracting State under Article 4 does not necessarily entitle a person to the benefits of the Convention. In addition to being

a resident, a person must qualify for benefits under Article 17 (Limitation on Benefits).

Under paragraph 1, the determination of residence for Convention purposes looks first to a person's liability to tax as a resident under the respective taxation laws of the Contracting States. Thus a person who is liable to tax under the laws of a Contracting State by reason of his domicile, residence, place of management, place of incorporation or any other similar criterion is treated as a resident of that State. A person who, under those laws, is a resident of one Contracting State and not of the other generally need look no further.

Paragraph 2 provides several exceptions to the general rule of paragraph 1. Under subparagraph 2(a), a person who is liable to tax in a Contracting State only in respect of income from sources within that State, or capital situated therein, will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, a Czech consular official who is posted in the United States, and who is subject to U.S. tax on U.S. source investment income but not on non-U.S. source income, would not be considered a resident of the United States for purposes of the Convention. (In most cases such an individual also would not be a U.S. resident under the Code.)

Under subparagraph 2(b), a partnership, estate or trust will be treated as a resident of a Contracting State to the extent that the income derived by the partnership, estate, or trust is subject to tax in that State as the income of a resident, whether in the hands of the partnership, estate or trust deriving the income or in the hands of its partners, beneficiaries or grantors. This rule is applied to determine the extent to which a partnership, estate or trust is entitled to Convention benefits with respect to income that it receives from the other Contracting State. Under U.S. law, a partnership (other than certain publicly traded limited partnerships and partnerships that are reclassified as associations under Treas. Reg. § 301.7701-2) is never, and an estate or trust often is not, a taxable entity. Thus, for Convention purposes, income received by a U.S. partnership need only be treated as received by a U.S. resident to the extent that it is included in the distributive share of partners who are U.S. residents (looking through any partnerships that are themselves partners). Similarly, the treatment under the Convention of income received by a U.S. trust or estate will be determined by the residence for taxation purposes of the person subject to tax on such income, which may be the grantor, the beneficiaries or the estate or trust itself, depending on the particular circumstances. A joint venture that is taxed in the Czech Republic as a resident enterprise will be a resident of the Czech Republic for Convention purposes, even if it is characterized as a partnership under U.S. law.

Under subparagraph 2(c), a U.S. citizen or a nonresident alien lawfully admitted for permanent residence (a "green card" holder) will be treated as a U.S. resident by the Czech Republic for purposes of the Convention only if such individual has a substantial presence, permanent home or habitual abode in the United States. Therefore, a U.S. citizen or "green card holder whose permanent home or habitual abode is not in the U.S. and not in the Czech Republic and who does not stay in the U.S. long enough to be a U.S. resident under code § 7701 will not be entitled to benefits under this treaty.

Under subparagraph 3(a), the two Contracting States, their political subdivisions and local authorities, and agencies and instrumentalities thereof, are to be treated as residents of those States for purposes of Convention benefits. Under subparagraph 3(b), a pension trust or any other organization that is constituted and operated exclusively to provide pension benefits or for religious, charitable, scientific, artistic, cultural or educational purposes and that, in any such case, is a resident of a Contracting State under the laws of that State is to be treated as a resident of that State for purposes of the Convention. This rule applies notwithstanding the fact that all or part of the organization's income may be exempt from income tax under the internal laws of that State.

Paragraph 4 provides a series of tie-breaker rules to determine a single State of residence for an individual who, under the laws of the two Contracting States, and thus under paragraph 1, is deemed to be a resident of both Contracting States. These rules come from the OECD Model. The first rule establishes residence where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State with which his personal and economic relations are closest, i.e., the location of his "center of vital interests." If that test is also inconclusive, or if he does not have a permanent home available to him in either State, he will be treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither of them, he will be treated as a resident of his Contracting State of citizenship. If he is a citizen of both States or of neither, the competent authorities are instructed to determine his residence by mutual agreement.

Paragraph 5 seeks to settle dual-residence issues for companies (defined in Article 3 (General Definitions) as entities treated as a body corporate for tax purposes). A company is treated as resident in the United States if it is created or organized under the laws of the United States or a political subdivision thereof. A company is treated as a resident of the Czech Republic if its place of registration is in the Czech Republic. In most cases it is expected that the place of

incorporation and registration will be the same. However, in the event that a company is a resident of both countries under their respective domestic laws, this paragraph provides that the company will be deemed to be a resident only of the State under whose laws it was created.

Paragraph 6 provides that where a person, other than an individual or a company, is a resident of both Contracting States under their respective laws, the competent authorities will establish a single country of residence by mutual agreement and determine how the Convention is to apply to such person.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment," which is relevant to several articles of the Convention. The existence of a permanent establishment in a Contracting State is necessary under Article 7 (Business Profits) for that State to tax the business profits of a resident of the other Contracting State. Articles 10 (Dividends), 11 (Interest) and 12 (Royalties) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment or fixed base that the recipient has in the source State. If the income is attributable to a permanent establishment, Article 7 (Business Profits) applies, and if the income is attributable to a fixed base, Article 14 (Independent Personal Services) applies.

Paragraph 1 provides the basic definition of the term "permanent establishment." As used in the Convention, the term means a fixed place of business through which the business of an enterprise is wholly or partly carried on. In the case of an individual, Article 14 (Independent Personal Services) uses the concept of a "fixed base," rather than a "permanent establishment," but the two concepts are considered to be parallel.

Paragraph 2 contains a list of examples of fixed places of business that constitute a permanent establishment: a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry or other place of extraction of natural resources. The use of singular nouns in this illustrative list is not meant to imply that each such place of business constitutes a separate permanent establishment. In the case of mines or wells, for example, several such places of business could constitute a single permanent establishment if the project is a whole commercially and geographically.

Subparagraph 3(a) adds that a building site or construction or installation project, or an installation or drilling rig or ship used to explore for or exploit natural resources, also constitutes a permanent establishment, but only if it lasts more than 12

months. This 12-month threshold is the same as that provided in the U.S. and OECD models and applies separately to each individual site or project. The testing period begins when work (including preparatory work carried on by the resident) physically begins in a Contracting State. A series of contracts or projects that are interdependent both commercially and geographically are to be treated as a single project. For example, the construction of a housing development would be considered a single project even if each house is constructed for a different purchaser. Likewise, the drilling of several wells within the same geographic area or by the same resident will be considered a single permanent establishment. If the 12-month threshold is exceeded, the site or project constitutes a permanent establishment from its first day. This interpretation of the Article is based on the Commentaries to paragraph 3 of Article 5 of the OECD Model, which constitute the generally accepted international interpretation of the language in paragraph 3 of Article 5 of the Convention.

Subparagraph 3(b) provides that the furnishing of services, including consultancy services, by an enterprise through employees or other personnel will constitute a permanent establishment, but only if activities of that nature continue (whether for the same or a connected project) within the country for a period or periods aggregating more than nine months within any 12-month period. A permanent establishment is not considered to exist, however, under either subparagraph 3(a) or 3(b) in any taxable year in which the activity described in such subparagraph continues for a period or periods aggregating less than 30 days in that taxable year.

Paragraph 4 lists a number of activities that may be carried on through a fixed place of business but that, nevertheless, will not give rise to a permanent establishment. Under subparagraph 4(a), the use of facilities solely to store, display or deliver merchandise belonging to an enterprise will not constitute a permanent establishment of that enterprise. Under subparagraphs 4(b) and (c), the maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise will not give rise to a permanent establishment of the first-mentioned enterprise. Under subparagraphs 4(d) and (e), the maintenance of a fixed place of business solely for purchasing goods or collecting information for the enterprise, or for carrying out any other activity of a preparatory or auxiliary character for the enterprise (e.g., advertising, the supply of information or certain research activities), will not constitute a permanent establishment of the enterprise. Finally, under subparagraph 4(f), a combination of the activities described in paragraph 4 will not give rise to a permanent establishment.

Paragraphs 5 and 6 specify when the use of an agent will constitute a permanent establishment. Under paragraph 5, a dependent agent of an enterprise is deemed to be a permanent

establishment of the enterprise if the agent has and habitually exercises an authority to conclude contracts in the name of that enterprise. If, however, his activities are limited to those activities specified in paragraph 4 that would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the agent is not a permanent establishment of the enterprise.

Under paragraph 6, an enterprise is not deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as an independent agent.

Paragraph 7 clarifies that a company that is a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it controls, or is controlled by, a company that is a resident of that other Contracting State, or that carries on business in that other Contracting State. The determination of whether a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

Article 6. INCOME FROM REAL PROPERTY (IMMOVABLE PROPERTY)

Paragraph 1 provides the general rule that income derived by a resident of a Contracting State from real property located in the other Contracting State (including income from agriculture or forestry) may be taxed in that other State. The income may also be taxed in the State of residence. Thus the Article does not grant an exclusive taxing right to the situs State, but merely grants it the primary right to tax. The Article does not impose any limitation in terms of rate or form of tax on the situs State, except that, as provided in paragraph 5, the situs State must allow the taxpayer an election to be taxed on a net basis.

Paragraph 2 defines the term "real property" by reference to the internal law of the situs State. In addition, the paragraph specifies certain classes of property that, regardless of internal law definitions, are to be included within the meaning of the term for purposes of the Convention. The term "real property" in no event includes ships, boats or aircraft.

Paragraph 3 clarifies that all forms of income from the exploitation of real property are taxable in the situs State, including but not limited to income from direct use of real property by the owner and rental income from the letting of real

property. Income from the disposition of real property, however, is not considered to be "derived" from real property and is not covered by this Article. The taxation of such income is addressed in Article 13 (Gains). Similarly, interest paid on a mortgage on real property and distributions by a U.S. Real Estate Investment Trust are not considered to be "derived" from real property. The taxation of these items is addressed in Articles 10 (Interest) and 11 (Dividends), respectively.

Paragraph 4 clarifies that income from real property of an enterprise is covered by this Article, and not by Article 7 (Business Profits). Similarly, income from real property used for the performance of independent personal services is covered by this Article, and not by Article 14 (Independent Personal Services). Thus the situs State may tax the real property income of a resident of the other State in the absence of attribution to a permanent establishment or fixed base.

Paragraph 5 provides that a resident of one Contracting State that derives real property income from the other Contracting State may be taxed in that other State on a net basis, as if the income were attributable to a permanent establishment in that other State. For purposes of taxation by the United States, an election to be taxed on a net basis will be binding for the taxable year of the election and for all subsequent taxable years, unless the U.S. competent authority agrees to terminate the election. The election is based on the U.S. Model provision, which reflects U.S. law (Code section 871(d)).

Article 7. BUSINESS PROFITS

This Article provides the rules for the taxation by a Contracting State of the business profits of an enterprise of the other Contracting State. Paragraph 1 provides the general rule that business profits (as defined in paragraph 7) of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on or has carried on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated there. Where that condition is met, the State in which the permanent establishment is situated may tax the business profits of the enterprise, but only so much as is attributable to the assets or activity of that permanent establishment.

Paragraph 2 provides that the Contracting States will attribute to a permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. The computation of business profits attributable to a permanent establishment under this paragraph is subject to the

rules of paragraph 3 for the allowance of expenses incurred for purposes of earning the income.

Profits attributable to a permanent establishment are taxable in the State where the permanent establishment is situated or was situated at the time the profits were derived. This rule incorporates the rule of Code section 864(c)(6) with respect to deferred payments, which is also reflected in the provisions of Articles 11 (Interest), 12 (Royalties), 14 (Independent Personal Services) and 22 (Other Income) dealing with amounts attributable to a permanent establishment or fixed base. If income was attributable to a permanent establishment or fixed base when earned, it is taxable by the State where the permanent establishment or fixed base was located, even if receipt of the income is deferred until the permanent establishment or fixed base has ceased to exist.

The concept of "attributable to" in paragraph 2 is analogous to, but narrower than, the concept of "effectively connected" in Code section 864(c). For example, the profits attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, Code section 864(c)(B) is consistent with paragraph 2, i.e., certain items of foreign source income described in Code section 864(c)(4)(B) may be attributed to a U.S. permanent establishment of a Czech resident and subject to tax in the United States. The "asset use" and "business activities" tests of Code section 864(c)(2) are also consistent with the "attributable to" concept. As discussed in connection with paragraph 5, however, the limited "force of attraction" rule in Code section 864(c)(3) is not applicable under the Convention.

Paragraph 3 provides that, in determining the business profits of a permanent establishment, deductions shall be allowed for expenses that are incurred for the purposes of the permanent establishment. These include expenses directly incurred by the permanent establishment and a reasonable allocation of expenses incurred by the home office, or by other permanent establishments of the home office, as long as the expenses were incurred on behalf of the company as a whole or a part of it that includes the permanent establishment. Allocable expenses include executive and general administrative expenses, research and development expenses, interest and other similar expenses, wherever incurred and without regard to whether they are actually reimbursed by the permanent establishment.

Paragraph 4 provides that no business profits will be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent establishment that performs more than one function for the enterprise, including purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's

manufacturing operation and sell the manufactured output. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable to it with respect to its purchasing activities. If the sole activity of the office were the purchasing of goods or merchandise for the enterprise, however, the issue of the attribution of income would not arise. Under subparagraph 4(d) of Article 5 (Permanent Establishment), the office would not be a permanent establishment to which profits could be attributed.

Under paragraph 5, the business profits attributed to a permanent establishment are only those profits derived from its assets or activities. This paragraph clarifies that the "limited force of attraction" concept of Code section 864(c)(3) is not incorporated into the Convention. The paragraph is also intended to assure consistent tax treatment over time for permanent establishments by providing that profits shall be determined by the same method of accounting each year, unless there is good reason to change the method used. This provision restricts both the Contracting State in changing accounting methods to be applied to permanent establishments and permanent establishments seeking to change accounting methods. This provision, however, does not restrict a Contracting State from imposing additional requirements on a permanent establishment, as provided in its law, in the event of a change in accounting method, to prevent amounts from being duplicated or omitted (see Code section 481).

Paragraph 6 provides that nothing in this Article shall affect the application of any law of a Contracting State relating to the determination of the tax liability of any person in cases where the information available to the competent authority of that State is inadequate to determine the profits to be attributed to a permanent establishment. In any such case, however, the determination of the profits of the permanent establishment must be consistent with the principles stated in this Article (to the extent possible based on the available information).

Paragraph 7 defines the term "business profits" to mean generally any income derived from any trade or business. Business profits include, specifically, income from the furnishing of the personal services of other persons, but do not include compensation received by an individual for the performance of personal service, whether as an employee or in an independent capacity. Thus a consulting firm resident in one State whose employees perform services in the other State through a permanent establishment may be taxed in that other State on a net basis under Article 7. The salaries of the employees, however, will be subject to the rules of Article 15 (Dependent Personal Services).

Paragraph 8 coordinates the provisions of this Article and other provisions of the Convention. Under paragraph 8, where business profits include items of income that are dealt with

separately under other articles of the Convention, the provisions of those articles will, except where they specifically provide to the contrary, take precedence over the provisions of Article 7. Thus, for example, the taxation of interest will be determined by the rules of Article 11 (Interest), and not by Article 7, except where (as provided in paragraph 4 of Article 11) the interest is attributable to a permanent establishment.

This Article is subject to the "saving" clause of paragraph 3 of Article 1 (General Scope) of the Model. Thus, if a citizen of the United States who is a resident of the Czech Republic under the Convention derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may, subject to the special foreign tax credit rules of paragraph 3 of Article 24 (Relief from Double Taxation), tax those profits, notwithstanding the provisions of this Article.

Article 8. SHIPPING AND AIR TRANSPORT

This Article governs the taxation of profits from the operation of ships and aircraft in international traffic. Under paragraph 1, profits derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic are taxable only in that State. By virtue of paragraph 8 of Article 7 (Business Profits), profits of an enterprise of a Contracting State that are exempt in the other Contracting State under this paragraph are exempt in that other State even if the enterprise has a permanent establishment there.

Paragraph 2 defines the term "profits from the operation of ships or aircraft in international traffic" to include profits derived from the rental of ships or planes on a full (time or voyage) basis (i.e., with crew) for use in international traffic. The term also includes profits derived from the leasing of ships or aircraft on a bareboat basis (i.e., without crew) for use in international traffic, provided that the lessor is an enterprise engaged in the operation of ships or aircraft in international traffic and the profits are incidental to such activities.

Paragraph 3 provides that profits derived by an enterprise of a Contracting State from the use, maintenance or rental of containers (including trailers, barges and related equipment for the transport of containers) used in international traffic are exempt from tax in the other Contracting State. This result obtains whether the enterprise is engaged in the operation of ships or aircraft in international traffic or is a leasing company, and whether or not the enterprise has a permanent establishment in that other Contracting State.

Paragraph 4 clarifies that the provisions of paragraph 1 apply to income from participation in a pool, joint business, or

international operating agency. This refers to various arrangements for international cooperation by carriers in shipping and air transport. For example, if the Czech airline were to form a consortium with other national airlines, the Czech participant's share of the total income derived by the consortium from U.S. sources would be covered by this Article.

Article 9. ASSOCIATED ENTERPRISES

This Article incorporates into the Convention the general principles of Code section 482. It provides generally that when a resident of one Contracting State engages in transactions with a related person resident in the other Contracting State, and such transactions are not conducted on an arm's length basis, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such persons to reflect the income or tax liability with respect to such transactions that each person would have had if the relationship between them had been at arm's length.

Paragraph 1 deals with the circumstances where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or when the same persons participate directly or indirectly in the management, control, or capital of an enterprise of one Contracting State and of an enterprise of the other Contracting State. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable. If, in either circumstance, the two enterprises make or impose conditions in their commercial or financial relations that differ from the conditions that would exist in relations between independent enterprises, the competent authorities may adjust the income of the related enterprises to reflect the profits that would have accrued to either enterprise if the two enterprises had been independent of each other.

Paragraph 2 provides that, where a Contracting State has made an adjustment that is consistent with the provisions of paragraph 1, the other Contracting State will make a corresponding adjustment to the tax liability of the related enterprise in that other State. It is understood that the other Contracting State need adjust its tax only if it agrees that the initial adjustment under paragraph 1 is appropriate. The Contracting State making an adjustment under this paragraph will take the other provisions of the Convention into account. For example, if the effect of a correlative adjustment is to treat a Czech corporation as having made a distribution of profits to its U.S. parent corporation, the provisions of Article 10 (Dividends) will apply to that distribution. The competent authorities are authorized to consult, if necessary, to resolve any differences in the application of this paragraph.

Paragraph 2 of Article 26 (Mutual Agreement Procedure) explains that any correlative adjustment made under this paragraph will be implemented, notwithstanding any time limits or procedural limitations in the law of the Contracting State making the adjustment. The "saving" clause of paragraph 3 of Article 1 (General Scope) does not apply to paragraph 2 of Article 9. Thus even if the statute of limitations has run, or there is a closing agreement between the Internal Revenue Service and the taxpayer, a refund of tax can be made in order to implement a correlative adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because, under paragraph 2 of Article 1 (General Scope), the Convention cannot restrict any statutory benefit.

Under paragraph 3, the provisions of paragraph 2 are not applicable in the case of fraud, gross negligence or willful default.

Article 10. DIVIDENDS

This Article provides rules for the taxation of dividends and similar amounts paid by a company resident in one Contracting State to a resident of the other Contracting State. The article permits full residence State taxation of such dividends and limited source State taxation. Article 10 also provides rules for the imposition of a tax on branch profits by the State of source.

Paragraph 1 preserves the residence State's general right to tax its residents on dividends paid by a company that is a resident of the other Contracting State. The same result is achieved by the "saving" clause of paragraph 3 of Article 1 (General Scope).

Paragraph 2 grants the source State the right to tax dividends paid by a company that is a resident of that State to a resident of the other Contracting State. If the beneficial owner of the dividend is a company that owns at least 10 percent of the voting shares of the company paying the dividend, the tax that may be imposed by the source State is limited to 5 percent of the gross amount of the dividend. In all other cases, the source State tax is limited to 15 percent of the gross amount of the dividend. Indirect ownership of voting shares (e.g., through tiers of corporations) and direct or indirect ownership of nonvoting shares are not considered for purposes of determining eligibility for the 5 percent direct investment dividend rate.

Paragraph 3 relaxes the limitations on source country taxation for dividends paid by a U.S. Regulated Investment Company (RIC) or Real Estate Investment Trust (REIT). A dividend paid by a RIC is subject to the 15 percent portfolio dividend rate, regardless of the percentage of voting shares of the RIC held directly by the recipient of the dividend. Generally, the reduction of the direct investment dividend rate to 5 percent is intended to relieve

multiple levels of corporate taxation in cases where the recipient of the dividend holds a substantial interest in the payor. This rationale does not justify a reduction of the rate in the case of dividends paid by RICs, because RICs do not pay corporate tax with respect to amounts distributed to their shareholders. Further, although amounts received by a RIC may have been subject to U.S. corporate tax (e.g., dividends paid by a publicly traded U.S. company to a RIC), it is unlikely that a 10 percent shareholding in a RIC by a Czech resident will correspond to a 10 percent shareholding in the entity that has paid U.S. corporate tax (e.g., the publicly traded U.S. company). Thus, in the case of dividends received by a RIC and paid out to its shareholders, the requirement of a substantial shareholding in the entity paying the corporate tax is generally lacking.

In the case of a dividend paid by a U.S. REIT to a Czech resident, the U.S. statutory rate i.e., 30 percent, generally applies (except in the case of amounts subject to tax as effectively connected income under Code section 897(h)). Dividends beneficially owned by an individual holding a less than 10 percent interest in the REIT are eligible, however, for the 15 percent portfolio dividend rate provided in paragraph 3. The denial of the 15 percent portfolio rate to corporate shareholders and 10 percent or greater individual shareholders is intended to prevent indirect investment in U.S. real property through a REIT from receiving more favorable treatment than direct investment in such real property.

Paragraph 4 defines the term "dividends," as used in this Article, to include income from any shares, "jouissance" rights, mining shares, founders' shares or other rights that are not debt claims and that participate in profits; income from other corporate rights that is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making a distribution is a resident; and income from arrangements, including debt obligations, if such arrangements carry the right to participate in profits and the income is characterized as a dividend under the domestic law of the Contracting State in which the income arises.

Paragraph 5 provides that, where dividends are attributable to a permanent establishment or fixed base that the beneficial owner maintains in the country of source, they are not subject to the provisions of paragraph 2 of this Article, but instead are taxable under Article 7 (Business Profits) or Article 14 (Independent Personal Services), as appropriate. Such dividends will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the Contracting State in which the permanent establishment or fixed base is located, as modified by the Convention.

Paragraph 6 permits a Contracting State to impose a "branch profits tax" on a corporation that is a resident of the other

State. Under paragraph 6, a Contracting State may impose a tax, in addition to other taxes permitted by the Convention, on a corporation that is a resident of the other Contracting State and that maintains a permanent establishment in the first mentioned State or that is subject to net basis taxation in that State under Article 6 (Income from Real Property (Immovable Property)) or Article 13 (Gains). The additional tax may not exceed 5 percent of the income of the corporation that is attributable to a permanent establishment in the taxing State or subject to tax on a net basis in that State, after deducting the taxes on profits imposed thereon in that other State and after adjustment for increases or decreases in the assets, net of liabilities, of the corporation connected with the permanent establishment or the trade or business. Such tax may only be imposed if, under the domestic law of the taxing State, it applies to the permanent establishment of any nonresident corporation. The U.S. tax will be imposed in accordance with Code section 884, subject to the limitation provided for in this Article. For U.S. tax purposes, the limitation is understood to correspond to 5 percent of the "dividend equivalent amount," as defined in Code section 884.

Under paragraph 7, where a company that is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid forms part of the business property of a permanent establishment or a fixed base situated in that other State. This result obtains even if the dividends paid consist wholly or partly of profits or income arising in such other State.

Article 11. INTEREST

Paragraph 1 grants to each Contracting State the exclusive right (subject to paragraphs 2 and 4) to tax interest beneficially owned by a resident of that Contracting State and arising in the other Contracting State.

Paragraph 2 reserves the right of the United States to tax an excess inclusion of a residual holder of a Real Estate Mortgage Investment Conduit (REMIC) in accordance with its law. Thus, the tax on such an excess inclusion of a Czech resident would be subject to the U.S. statutory rate of withholding tax, i.e., 30 percent.

Paragraph 3 defines the term "interest," as used in the Convention, to include income from debt claims of every kind, whether or not secured by a mortgage, and, subject to paragraph 4 of Article 10 (Dividends), whether or not carrying a right to participate in profits. The term "interest" includes, in

particular, income from government securities, income from bonds or debentures, and any premiums or prizes attaching to such securities, bonds or debentures, and all other income treated as interest by the taxation law of the source State. The definition does not refer to penalties and fines for late payment, which are frequently excluded from the treaty definition of interest. However, such amounts would also be exempt from tax at source under Article 22 (Other Income).

Paragraph 4 provides an exception from the rule of paragraph 1 in cases where the beneficial owner of the interest, who is a resident of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed based situated in that other State and the interest is attributable to that permanent establishment or fixed base. In such a case, the income is taxable to the permanent establishment or fixed base in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services). This rule applies even if the permanent establishment or fixed base no longer exists when the interest is received or accrued, as long as the interest would have been attributable to the permanent establishment or fixed base if it had been received or accrued in the earlier year, i.e., because the debt claim on which the interest is paid was attributable to the permanent establishment in such earlier year.

Paragraph 5 provides a source rule for interest. Under this paragraph, interest is deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the payer (whether or not a resident of a Contracting State) has in a Contracting State a permanent establishment or fixed base, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

Paragraph 6 provides that if, as a result of a special relationship between the payer and the beneficial owner of the interest, or between both of them and some other person, the interest paid is excessive, Article 11 applies only to the amount of interest payments that would have been made absent such special relationship (i.e., an arm's length interest payment). Any excess amount of interest paid remains taxable according to the laws of the United States and the Czech Republic, respectively, with due regard to the other provisions of the Convention. Thus, for example, if the excess amount would be treated as a distribution of profits, such amount could be taxed as a dividend, rather than as interest, subject to the provisions of Article 10 (Dividends).

Because the rule of paragraph 2 provides for exemption at source of interest derived by a resident of the other Contracting State, the United States will not impose tax under Code section 884 on excess interest of a U.S. branch of a Czech company.

Article 12. ROYALTIES

Paragraph 1 grants to each Contracting State the right (subject to paragraph 2, discussed below) to tax royalties beneficially owned by its residents and arising in the other Contracting State.

Paragraph 3 defines the term "royalties" as used in the Convention. Under subparagraph 3(a), the term "royalties" includes payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematographic films or films or tapes and other means of image or sound reproduction. The reference to "other means" of reproduction makes clear that subsequent technological advances will not affect the exclusion of payments relating to the use of such means of image or sound reproduction from the definition of royalties. Under subparagraph 3(b), the term also includes payments for the use of, or right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for industrial, commercial, or scientific equipment or for information concerning industrial, commercial, or scientific experience. In addition, the term "royalties" includes gains from the alienation of any right or property described in paragraph 3 that is contingent on the productivity, use, or further disposition of the property.

Under paragraph 2, royalties described in subparagraph 3(a) ("copyright royalties") that are paid by a resident of one Contracting State and beneficially owned by a resident of the other Contracting State are taxable only in that other Contracting State, i.e., the residence State of the beneficial owner. The scope of the term "copyright" as used in the paragraph is determined under domestic law. Royalties described in subparagraph 3(b) ("industrial royalties") may be taxed both by the source State and by the residence State of the beneficial owner, but the tax that may be imposed by the source State is limited to 10 percent of the gross amount of the royalties. Taxation of any royalties arising in one Contracting State and derived and beneficially owned by a resident of the other Contracting State is a departure from the U.S. model. Inclusion of equipment rentals under the definition of royalties is a further departure from the U.S. model. However, like a number of countries, the Czech Republic feels strongly about this point and the maximum treaty rate of 10% does represent a significant reduction of the Czech nontreaty rate of 25%.

Paragraph 4 provides an exception to the rules of paragraphs 1 and 2 in cases where a beneficial owner of royalties who is a resident of one Contracting State carries on or has carried on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base in that other State and the royalties are attributable to that

permanent establishment or fixed base, i.e., the right or property in respect of which the royalties are paid forms part of the business property of such permanent establishment or fixed base. In such a case, the royalties are taxable in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), and the source State will generally retain the right of taxation. This rule applies even if the permanent establishment or fixed base no longer exists when the royalties are paid or accrued, as long as the royalties would have been attributable to the permanent establishment or fixed base if they had been paid or accrued in the earlier year, e.g., because the license in respect of which the royalties are paid was attributable to the permanent establishment in such earlier year.

Paragraph 5 provides that if, as a result of a special relationship between the payer and the beneficial owner of a royalty, or between both of them and some other person, the royalty paid is excessive, Article 12 applies only to the amount of the royalty payment that would have been made absent such special relationship (i.e., an arm's length royalty payment). Any excess amount of royalty paid remains taxable according to the laws of the United States and the Czech Republic, respectively, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of profits by a company under the internal law of the source State, such excess amount will be taxed as a dividend, rather than as a royalty payment, subject to the provisions of Article 10 (Dividends).

Paragraph 6 provides source rules for royalty payments. Under subparagraph 6(a), royalties are treated as arising in a Contracting State when the payer is that State itself, a political subdivision or local authority of that State or a person who is a resident of that State for purposes of its tax. Where, however, the person paying the royalties (whether or not a resident of one of the Contracting States) has in a Contracting State a permanent establishment or fixed base in connection with which the liability to pay royalties was incurred, and the royalties are borne by the permanent establishment or fixed base, then the royalties are deemed to arise in the State in which the permanent establishment or fixed base is situated. Where subparagraph 6(a) does not apply to treat royalties as arising in a Contracting State, subparagraph 6(b) treats royalties paid for the use of, or the right to use, any property or right described in paragraph 3 in a Contracting State as arising in that State.

Article 13. GAINS

This Article provides rules for source and residence State taxation of gains from the alienation of property.

Paragraph 1 provides that gains derived by a resident of one Contracting State from the alienation of real property situated in the other Contracting State may be taxed in the other (situs) State.This paragraph is intended to preserve the right of the United States to tax the full range of gains taxable under section 897 of the Code.

For purposes of Article 13, paragraph 2 defines the term "real property situated in the other Contracting State" to include real property referred to in Article 6 (Income from Real Property (Immovable Property)) (i.e., interests in the immovable property itself) and certain indirect interests in real property. Such indirect interests include shares of stock in a company at least 50 percent of the assets of which consist of real property situated in the source State. Thus, a Czech resident would be subject to U.S. tax on gain from the alienation of shares in a United States Real Property Holding Corporation. Similarly, such a resident would be subject to tax on a liquidating distribution by such a U.S. corporation and on a distribution by a REIT attributable to gain from the alienation of U.S.-situs real property. This provision also preserves the U.S. right to tax gain from the alienation of an interest in a partnership, trust or estate, to the extent that the gain is attributable to U.S.-situs real property.

Paragraph 3 preserves the right of the source State to tax gains from the alienation of personal (movable) property in certain circumstances. Under paragraph 3, gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State, or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

Paragraph 4 provides that gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft or containers used in international traffic are taxable only in that State.

Paragraph 5 clarifies that payments described in paragraph 3 of Article 12 (Royalties), including gains from the alienation of any right or property described in paragraph 3 of Article 12 that is contingent on the productivity, use, or further disposition of the property, are taxable only in accordance with the provisions of Article 12.

Paragraph 6 grants to the residence State the exclusive right to tax gains from the alienation of property other than property referred to in paragraphs 1 through 5.

Article 14. INDEPENDENT PERSONAL SERVICES

The Convention deals in separate articles with different classes of income from personal services. Article 14 deals with the general class of income from independent personal services, and Article 15 deals with the general class of income from employment (dependent personal services). Exceptions and additions to these general rules are provided for directors' fees in Article 16; for performance income of artistes and sportsmen in Article 18; for pensions in respect of personal service income and social security benefits in Article 19; for government service salaries and pensions in Article 20; and for certain income of students, trainees, teachers and researchers in Article 21.

Under paragraph 1, income derived by an individual who is a resident of one Contracting State from the performance of personal services in an independent capacity in the other Contracting State is exempt from tax in that other State unless the services are or were performed in that other State (see Code section 864(c)(6)) and either (a) the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his services, in which case the income attributable to that fixed base may be taxed in that other State, or (b) the individual remained in that other State for more than an aggregate of 183 days in any twelve month period. The State of residence may tax in either case under paragraph 3 of Article 1 (General Scope). In addition, under paragraph 3 of Article 1 (General Scope), if the individual is a Czech resident who performs independent personal services in the United States, and the individual is also a U.S. citizen, the United States may tax his income without regard to the restrictions of this Article, subject to the special foreign tax credit rules of paragraph 3 of Article 24 (Relief from Double Taxation).

The term "fixed base" is not defined in the Convention, but its meaning is understood to be analogous to that of the term "permanent establishment." Therefore, it is understood that the income attributed to a fixed base will be taxed in accordance with principles similar to those provided in Article 7 (Business Profits) for the taxation of business enterprises. However, in this case, only income from services performed in a Contracting State may be attributed to a fixed base in that State.

Paragraph 2 notes that the term "personal services" includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list, which is derived from the OECD Model, is not exhaustive. The term includes all personal services performed by an individual for his own account, where he receives the income and bears the risk of loss arising from the services. The taxation of income from the

types of independent services that are covered by Articles 16 and 18 through 21 is governed by the provisions of those articles.

Article 15. DEPENDENT PERSONAL SERVICES

This Article deals with the taxation of remuneration derived by a resident of a Contracting State for the performance of personal services in the other Contracting State as an employee.

Under paragraph 1, remuneration derived by an employee who is a resident of a Contracting State may be taxed by his State of residence. This is the same result as achieved by paragraph 3 of Article 1 (General Scope). However, to the extent that the remuneration is derived from an employment exercised (the performance of services) in the other Contracting State, the remuneration also may be taxed by that other Contracting State unless the conditions specified in paragraph 2 are satisfied.

Paragraph 1 also provides that the more specific rules of Articles 16 (Directors' Fees), 19 (Pensions, Annuities, Alimony, and Child Support), 20 (Government Service), and 21 (Students, Trainees, Teachers, and Researchers) apply in the case of employment income described in one of these articles. Thus, even though the State of source has a general right to tax employment income under Article 15, it may not have the right to tax a particular type of income under the Convention if that right is proscribed by one of the aforementioned articles. Similarly, though a State of source may have no general right of taxation under Article 15 with respect to a particular item of income, the State may have the right to tax that income under one of the aforementioned Articles.

Under paragraph 2, remuneration of an individual resident of a Contracting State that is derived from the performance of services as an employee within the other Contracting State may not be taxed by that other Contracting State if three conditions are satisfied: (a) the individual is present in that State for a period or periods not exceeding in the aggregate 183 days in any twelve month period; (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other Contracting State; and (c) the remuneration is not borne by a permanent establishment or fixed base that the employer has in that other State. If a foreign employer pays the salary of an employee, but a host country corporation or permanent establishment reimburses the foreign employer in a deductible payment that can be identified as a reimbursement, neither condition (b) nor (c) will be considered to have been fulfilled. Conditions (b) and (c) are intended to ensure that a Contracting State will not be required both to allow a deduction to the payor for the amount paid and to exempt the employee on the amount received. In order for the remuneration to

be exempt from tax in the source State, all three conditions must be satisfied.

Paragraph 3 contains a special rule applicable to remuneration for services performed by an individual who is a resident of a Contracting State as an employee aboard a ship or aircraft operated in international traffic. Such remuneration may be taxed only in the Contracting State of residence of the employee if the services are performed as a member of the regular complement of the ship or aircraft. This rule is similar to the corresponding provision in the U.S. Model. The "regular complement" of a ship or aircraft includes the crew. In the case of a cruise ship, it may also include others, such as entertainers, lecturers, etc., employed by the shipping company to serve on the ship. The use of the term "regular complement" is intended to clarify that a person who exercises his employment as, for example, an insurance salesman while aboard a ship or aircraft is not covered by this paragraph.

If a U.S. citizen who is resident in the Czech Republic performs dependent services in the United States and meets the conditions of paragraph 2, or is a crew member on a Czech ship or airline, and would therefore be exempt from U.S. tax if he were not a U.S. citizen, he is nevertheless taxable in the United States on his remuneration by virtue of the saving clause of paragraph 3 of Article 1 (General Scope), subject to the special foreign tax credit rules of paragraph 3 of Article 24 (Relief from Double Taxation).

Article 16. DIRECTORS' FEES

This Article provides that a Contracting State may tax the fees paid by a company that is a resident of that State for services performed by a resident of the other Contracting State in his capacity as a director of the company, provided that the services are performed in the first-mentioned State. This rule is an exception to the more general rules of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services). Thus, for example, in determining whether a non-employee director's fee is subject to tax in the State of residence of the company, whether the company constitutes a fixed base of the director in that State is not relevant.

The rule provided in this Article represents a departure from the U.S. Model, which treats a corporate director in the same manner as any other individual performing personal services -- outside directors would be subject to the provisions of Article 14 (Independent Personal Services) and inside directors would be subject to the provisions of Article 15 (Dependent Personal Services). The preferred Czech position is reflected in the OECD Model, in which a resident of one Contracting State who is a

director of a company that is resident in the other Contracting State is subject to tax in that other State in respect of his directors' fees regardless of where the services are performed. The provision in Article 16 of the Convention represents a compromise between these two positions. The State of residence of the company may tax nonresident directors with no threshold, but only with respect to remuneration for services performed in that State.

This Article is subject to the "saving" clause of paragraph 3 of Article 1 (General Scope). Thus, if a U.S. citizen who is a Czech resident is a director of a U.S. corporation, the United States may tax his full remuneration regardless of the place of performance of his services.

Article 17. LIMITATION ON BENEFITS

Article 17 ensures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State -- and are not extended to residents of third States not having a substantial business in, or business nexus with, the other Contracting State. For example, a resident of a third State might establish an entity resident in a Contracting State for the purpose of deriving income from the other Contracting State and claiming source State benefits with respect to that income. Absent Article 17, the entity would generally be entitled to benefits as a resident of a Contracting State, subject to such limitations, e.g., business purpose, substance-over-form, step transaction or conduit principles, as may be applicable to the transaction or arrangement under the domestic law of the source State.

Article 17 is more detailed than the corresponding article in the U.S. Model and follows the form of the article used in more recent treaties. See, e.g., Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes. The structure of the Article is as follows: Paragraph 1 lists a series of attributes of a resident of a Contracting State, any one of which will entitle that person to benefits of the Convention in the other Contracting State. Paragraph 2 provides that benefits also may be granted to a person not entitled to benefits under the tests of paragraph 1, if the competent authority of the source State determines that it is appropriate to provide benefits in that case. Paragraph 3 defines the term "recognized securities exchange" as used in subparagraph 1(c). Paragraph 4 defines the term "gross income" as used in subparagraph 1(e)(ii).

The first two categories of persons eligible for benefits from the other Contracting State under the Convention are individual

residents of a Contracting State (subparagraph 1(a)) and the two Contracting States and their political subdivisions or local authorities (subparagraph 1(b)). It is considered unlikely that persons falling into these two categories can be used improperly to derive treaty benefits on behalf of a third-country resident. If an individual is receiving income as a nominee on behalf of a third-country resident, benefits will be denied with respect to those items of income under the articles of the Convention that grant the benefit, because of the requirements in those articles that the beneficial owner (and not merely the recipient) of the income be a resident of a Contracting State.

The third category, described in subparagraph 1(c), consists of persons that are residents of one Contracting State and derive income from the other Contracting State that is connected with, or incidental to, an active trade or business conducted in the residence State. Income that is derived in connection with, or is incidental to, the business of making or managing investments will not qualify for benefits under this provision, unless the business is a bank or insurance company engaged in banking or insurance activities. The first six examples in the Memorandum of Understanding Regarding the Scope of the Limitation on Benefits Article in the Convention Between the Federal Republic of Germany and the United States of America (German Convention) illustrate the situations covered by subparagraph 1(c).

The fourth category, described in subparagraph 1(d), consists of companies in whose principal class of shares there is substantial and regular trading on a recognized securities exchange (as defined in paragraph 3) and companies that are wholly owned, directly or indirectly, by a company that is a resident of the same Contracting State and whose principal class of shares are so traded.

The fifth category, described in subparagraph 1(e), includes not-for-profit organizations (including a pension fund or private foundation) that satisfy two conditions: (a) the organization is generally exempt from tax in its State of residence by virtue of its not-for-profit status and (b) more than half of the beneficiaries, members, or participants, if any, in the organization are persons who are entitled under this Article to benefits of the Convention.

The sixth category, described in subparagraph 1(f) of paragraph 1, includes persons who satisfy two tests: the so-called "ownership" and "base erosion" tests. The "ownership" test requires that more than 50 percent of the beneficial interest in the person (or, in the case of a company, more than 50 percent of each class of its shares) be owned, directly or indirectly, by persons who are themselves entitled to benefits under the other tests of paragraph 1 (other than subparagraph c)). The "base erosion" test requires that not more than 50 percent of the

person's gross income (as defined in paragraph 4) be used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to benefits under the other tests of paragraph 1 (other than subparagraph c)).

The rationale for the two-part test of subparagraph 1(f) derives from the fact that treaty benefits can be indirectly enjoyed not only by equity holders of an entity, but also by that entity's various classes of obligees, such as lenders, licensors, service providers, insurers and reinsurers, and others. In order to prevent such benefits from inuring substantially to third-country residents, it is not sufficient merely to require substantial ownership of the entity by treaty country residents or their equivalent. It is also necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or their equivalents. For example, a third-country resident could lend funds to a Czech-owned Czech corporation to be reloaned to the United States. The U.S. source interest income of the Czech corporation would be exempt from U.S. withholding tax under Article 11 (Interest) of the Convention. While the Czech corporation would be subject to Czech income tax, its taxable income could be reduced to near zero by the deductible interest paid to the third-country resident. If, under a Convention between the Czech Republic and the third country, that interest is exempt from Czech tax, the U.S. treaty benefit with respect to the U.S. source interest income will have flowed to the third-country resident.

It is intended that the provisions of paragraph 1 will be self-executing. Unlike the provisions of paragraph 2, discussed below, a claim of benefits under paragraph 1 does not require advance competent authority ruling or approval. The tax authorities may, of course, determine on review that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

Paragraph 2 of Article 17 permits the competent authority of the State in which income arises to grant Convention benefits in additional cases, even if they do not meet the standards of paragraph 1 (or sufficient information is not available to make such a determination). This discretionary provision is included in recognition that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third-country residents in an enterprise of a Contracting State is warranted by sound business practice and does not indicate a motive of attempting to derive unintended Convention benefits.

Paragraph 3 defines the term "recognized securities exchange" as used in subparagraph 1(d). In the case of the United States, this term means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with

the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934. In the case of the Czech Republic, the term means the Czech stock exchange (Burza Cennycn Papiru Praha, A.S.) and any other stock exchange approved by the Czech State authorities. The term "recognized securities exchange" also includes any other stock exchange agreed upon by the competent authorities.

Paragraph 4 defines the term "gross income," as used in subparagraph 1(e)(ii), generally to mean gross receipts. In the case of an enterprise engaged in a manufacturing or production business, the term "gross income" means gross receipts reduced by the direct costs of labor and materials attributable to such manufacture or production and paid or payable out of such receipts.

Article 18. ARTISTES AND SPORTSMEN

Article 18 addresses the taxation in a Contracting State of artistes (i.e., performing artists and entertainers) and athletes resident in the other Contracting State from the performance of their services as such. The Article applies both to the income of an entertainer or athlete who performs services on his own behalf and one who performs his services on behalf of another person, either as an employee of that person or pursuant to any other arrangement. The rules of this Article take precedence over those of Article 14 (Independent Personal Services) and 15 (Dependent Personal Services). This Article applies, however, only with respect to the income of performing artists and athletes. Others involved in a performance or athletic event, such as producers, directors, technicians, managers, coaches, etc., remain subject to the provisions of Articles 14 and 15.

Paragraph 1 describes the circumstances in which a Contracting State may tax the performance income of an entertainer or athlete who is a resident of the other Contracting State. Under the paragraph, income derived by a resident of a Contracting State from his personal activities as an entertainer or athlete exercised in the other Contracting State may be taxed in that other State if the amount of the gross receipts derived by the individual exceeds $20,000 (or its equivalent in Czech crowns) for the taxable year concerned. The $20,000 includes expenses reimbursed to the individual or borne on his behalf. If the gross receipts exceed $20,000, the full amount, not just the excess, may be taxed in the State of performance.

The OECD Model provides for taxation by the country of performance of the remuneration of entertainers with no dollar or time threshold. The United States introduces the dollar threshold test to distinguish between two groups of entertainers and athletes -- those who are paid very large sums of money for very short periods of service, and who would, therefore, normally be exempt

from host country tax under the standard personal services income rules, and those who earn only modest amounts and are, therefore, not clearly distinguishable from those who earn other types of personal service income.

Paragraph 1 applies notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services) or 15 (Dependent Personal Services). Thus, if an individual would otherwise be exempt from tax under those Articles, but is subject to tax under this Article, he may be taxed. An entertainer or athlete who receives less than the $20,000 threshold amount, and who is, therefore, not affected by this Article, may nevertheless be subject to tax in the host country under Article 14 or 15 if the tests for taxability under those Articles are met. For example, if an entertainer who is an independent contractor earns only $19,000 of income for the calendar year, but the income is attributable to a fixed base regularly available to him in the State of performance, that State may tax his income under Article 14. It is frequently not possible to know until year end whether the income and entertainer or athlete derived from performance in a Contracting State will exceed $20,000. Nothing in the Convention precludes that Contracting State, however, from withholding tax during the year and refunding after the close of the year if the taxability threshold has not been met.

Paragraph 2 is intended to deal with the potential for abuse when income from a performance by an entertainer or athlete does not accrue to the performer himself, but to another person. Foreign entertainers commonly perform in the United States as employees of, or under contract with, a company or other person. The relationship may truly be one of employee and employer, with no abuse of the tax system either intended or realized. On the other hand, the "employer" may be, for example, a company established and owned by the performer that is merely acting as the nominal income recipient in respect of the remuneration for the performer's performance. The performer may be acting as an "employee," receiving a modest salary and arranging to receive the remainder of the income from his performance in another form or at a later time. In such a case, absent the provisions of paragraph 2, the company providing the entertainer's services can escape host country tax because it earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host country tax by receiving only a small salary in the year the services are performed, perhaps small enough to place him below the dollar threshold in paragraph 1. He would arrange to receive further payments in a later year, when he is not subject to host country tax, perhaps as salary payments, dividends, or liquidating distributions.

Paragraph 2 seeks to prevent this type of abuse while at the same time protecting the taxpayers' rights to the benefits of the Convention when there is a legitimate employee-employer

relationship between the performer and the person providing his services. Under paragraph 2, when the income accrues to a person other than the performer, and the performer (or persons related to him) participate, directly or indirectly, in the profits of that other person, the income may be taxed in the Contracting State where the performer's services are exercised, without regard to the provisions of the Convention concerning business profits (Article 7) or independent personal services (Article 14). Thus, even if the "employer" has no permanent establishment or fixed base in the host country, its income may be subject to tax there under the provisions of paragraph 2. Taxation under paragraph 2 is on the person providing the services of the entertainer or athlete. This paragraph does not affect the rules of paragraph 1, which apply to the entertainer or athlete himself. To the extent of salary payments to the performer, which are treated under paragraph 1, the income taxable by virtue of paragraph 2 to the person providing his services is reduced.

For purposes of paragraph 2, income is deemed to accrue to another person (i.e., the person providing the services of the entertainer or athlete) if that other person has control over, or the right to receive, gross income in respect of the services of the entertainer or athlete. Direct or indirect participation in the profits of a person may include, but is not limited to, the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income or other income or distributions.

The paragraph 2 override of the protection of Articles 7 (Business Profits) and 14 (Independent Personal Services) does not apply if it is established that neither the entertainer or athlete, nor any persons related to the entertainer or athlete, participate directly or indirectly in the profits of the person providing the services of the entertainer or athlete. Thus, for example, if a circus owned by a U.S. corporation performs in Prague, the Czech promoters of the performance pay the circus, which in turn pays salaries to the clowns. The circus has no permanent establishment in the Czech Republic. Since the clowns do not participate in the profits of the circus, but merely receive their salaries out of the circus' gross receipts, the circus is protected by Article 7 and its income is not subject to Czech tax. Whether the salaries of the clowns are subject to Czech tax depends on whether they exceed the $20,000 threshold in paragraph 1. This exception for non-abusive cases to the paragraph 2 override of the Articles 7 and 14 protection of persons providing the services of entertainers and athletes is not found in the OECD Model. The policy reflected in this exception is, however, consistent with the stated intent of Article 17 of that Model, as indicated in its Commentaries. The Commentaries to Article 17 state that paragraph 2 is intended to counteract certain tax avoidance devices in which income is diverted from the performer to another person in order to minimize the total tax on the remuneration. It is therefore consistent not to apply these rules in non-abusive cases.

Paragraph 3 is not found in the U.S. or OECD Models. It provides an exception to the rules in paragraphs 1 and 2 in the case of a visit to a Contracting State by an entertainer or athlete who is a resident of the other Contracting State, if the visit is substantially supported, directly or indirectly, by the public funds of his State of residence or of a political subdivision or local authority of that State. In the circumstances described, only the Contracting State of residence of the entertainer or athlete may tax his income from the performances so supported in the other State.

This Article is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope). Thus, if an entertainer or athlete who is a resident in the Czech Republic is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of this Article, subject, however, to the special foreign tax credit provisions of paragraph 3 of Article 24 (Relief from Double Taxation).

Article 19. PENSIONS, ANNUITIES, ALIMONY, AND CHILD SUPPORT

This Article deals with the taxation of private and public pensions and annuities, alimony and child support payments.

Paragraph 1 provides in subparagraph a) that pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment may be taxed only by the State of residence of the beneficial owner. The past employment need not have been exercised by the beneficial owner of the pension. For example, a pension paid to a surviving spouse who is a resident of the Czech Republic would be exempt from tax by the United States on the same basis as if the right to the pension had been earned directly by the surviving spouse. A pension may be paid in installments or in a lump sum.

Subparagraph 1(b) provides that social security benefits and other public pensions paid by a Contracting State to a resident of the other Contracting State or a citizen of the United States may be taxed only by the paying State. This rule applies to benefits paid under the social security legislation of both Contracting States and certain U.S. Railroad Retirement benefits.

The rule of subparagraph 1(b) is an exception to the "saving" clause of paragraph 3 of Article 1 (General Scope). Thus, a Czech social security benefit will be exempt from U.S. tax even if the beneficiary is a U.S. resident or a U.S. citizen (whether resident in the United States, the Czech Republic, or a third country). The rules of paragraph 1 do not apply to pensions for governmental service, which are dealt with in Article 20 (Government Service).

Under paragraph 2, annuities that are derived and beneficially owned by a resident of a Contracting State are taxable only in that State. An annuity, as the term is used in this paragraph, means a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payment in return for adequate and full consideration (other than for services rendered).

Paragraphs 3 and 4 deal with alimony and child support payments. The provisions of the two paragraphs differ, in some respects, from the comparable provisions in the U.S. Model so that they may better coordinate the provisions of U.S. and Czech law regarding the treatment of such payments. Paragraph 3 deals only with those alimony payments that are deductible to the payor. Under the paragraph, alimony paid by a resident of a Contracting State, to the extent that it is deductible by that resident, to a resident of the other Contracting State is taxable only in the State of residence of the recipient. Paragraph 4 deals with nondeductible alimony and periodic payments for the support of a minor child. These types of payments by a resident of a Contracting State to a resident of the other Contracting State are taxable only in the State of residence of the payor.

Both alimony, under paragraph 3, and nondeductible alimony and child support payments, under paragraph 4, are defined as periodic payments made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support. In addition, for a payment to be treated as "alimony" for purposes of this Article, it must be taxable to the recipient under the laws of his State of residence.

Under U.S. law, alimony is generally deductible to the payer and taxable in the hands of the recipient. Such payments made by U.S. residents, therefore, fall within the terms of paragraph 3 and are taxable only in the Czech Republic. Under Czech law, to the extent alimony is deducted by the payer, it is taxable to the recipient. In such cases, alimony paid by Czech residents also falls under paragraph 3.

The "saving" clause of paragraph 3 of Article 1 does not apply to paragraph 4. The benefits of this paragraph, therefore, are not overridden by any contrary provisions of the Code.

Article 20. GOVERNMENT SERVICE

This Article follows the corresponding provisions of the OECD Model. The Article provides generally that payments (including a pension) from the public funds of a Contracting State or political subdivision or local authority thereof to compensate a citizen of that State for the performance of services rendered in the discharge of functions of a governmental nature may be taxed only

by that State. Payments in respect of services rendered in connection with a business carried on by that State, political subdivision or local authority (for example, a government-operated airline) are governed by the provisions of Article 14 (Independent Personal Services), 15 (Dependent Personal Services) or 18 (Artistes and Sportsmen), as the case may be, and not by Article 20.

The provisions of this Article do not apply to social security benefits and other public pensions that are not paid in respect of services rendered to the paying government or a political subdivision or local authority thereof. Such amounts are governed by the provisions of Article 19 (Pensions, Annuities, Alimony and Child Support).

The rules of this Article are an exception to the "saving" clause of paragraph 3 of Article 1 (General Scope) for individuals who are neither citizens nor permanent residents of the State where the services are performed. Thus, for example, payments by the Czech Republic to its employees at the Czech Embassy in Washington are exempt from U.S. tax if the employees are not "green card" holders or citizens of both countries.

Article 21. STUDENTS, TRAINEES, TEACHERS AND RESEARCHERS

This Article deals with visiting students, trainees, and, unlike the U.S. Model, teachers and researchers.

Paragraph 1 deals with certain payments received by a student who is temporarily present in the host State for the primary purpose of study at an accredited educational institution, securing professional training, or study or research as the recipient of a grant from a governmental, religious, charitable, scientific, literary or educational organization. If such a student was a resident of the other Contracting State at the beginning of his visit, he will be exempt from tax in the host State on (i) payments (other than compensation for personal services) arising from sources, or remitted from, outside the host State, that are for the purpose of the student's or trainee's maintenance, education or training, (ii) the study or research grant, and (iii) income from personal services performed in the host State in an aggregate amount not exceeding $5,000 or its equivalent in Czech crowns for any taxable year. These exemptions are available for a period of time not exceeding five years from the date of the student's arrival in the host State. It is expected that, in most cases, study, training or research programs would be completed within five years.

The reference in paragraph 1 to "primary purpose" is meant to describe individuals participating in a full-time program of study, training, or research. It was substituted for the reference in the

OECD Model to "exclusive purpose" to prevent too narrow an interpretation. It is not the intention to exclude full-time students who, in accordance with their visas, may hold part-time employment jobs. For U.S. purposes, a religious, charitable etc. organization as described in subparagraph 1(c) is an organization that qualifies as tax-exempt under Code section 501(c)(3).

Paragraph 2 deals with a resident of a Contracting State who is an employee of an enterprise of that State and who is temporarily present in the other Contracting State for the primary purpose of studying at an accredited educational institution in the host State or acquiring technical, professional or business experience from a person other than his employer. Such resident will be exempt from tax by the host State for a period of 12 consecutive months on compensation for personal services, wherever performed, in an aggregate amount not exceeding $8,000 or its equivalent in Czech crowns.

Paragraph 3 of the Article deals with a resident of a Contracting State who is temporarily present in the other Contracting State for a period not exceeding one year, as a participant in a program sponsored by the Government of the host State, for the primary purpose of training, research or study. Such an individual will be exempt from tax by the host State on compensation for personal services in respect of such training, research or study performed in the host State in an aggregate amount not exceeding $10,000 or its equivalent in Czech crowns.

Paragraph 4 permits the competent authorities to agree to adjust the dollar amounts specified in paragraphs 1 through 3 to reflect significant changes in price levels over time. The exemption for income from personal services in paragraphs 1 through 3 applies only if the services are performed solely for the purposes of supplementing the funds otherwise available for the person's maintenance, education or training. The $5,000 exemption applies in addition to, and not in lieu of, any allowances (e.g., personal exemptions and deductions) available to the person under the internal laws of the Contracting States. If the amount earned exceeds $5,000 per annum, only the excess is taxable.

Paragraph 5 of the Article deals with visiting professors and teachers. Although there is no provision in the U.S. or OECD Models dealing with professors or teachers, and it is not standard U.S. treaty policy to provide benefits to visiting teachers by treaty, the United States will frequently agree to include such a provision when requested by the treaty partner. Paragraph 5 provides that if a professor or teacher who is a resident of one Contracting State visits the other Contracting State for a period not exceeding two years for the purpose of teaching or conducting research at an accredited educational or research institution, he will be exempt from tax in the host State on his compensation for such teaching or research. A person is not entitled to the

benefits of this paragraph if he has, during the immediately preceding period, enjoyed the benefits of paragraph 1, 2 or 3 of Article 21 as a student, apprentice or trainee. If, however, following the period in which a person claimed benefits under paragraph 1, 2 or 3, that person resumes residence and physical presence in his original home State before returning to the host State as a teacher or researcher, he may claim the benefits of paragraph 5. The benefits of paragraph 5 may be claimed only once by a particular individual.

Paragraph 6 clarifies that, for the exemption of paragraph 5 to apply to income from research, the research must be undertaken in the public interest, and not primarily for the private benefit of a specific person or persons. For example, the exemption would not apply to a grant from a tax-exempt research organization to search for the cure to a disease if the results of the research become the property of a for-profit company. The exemption would not be denied, however, if the tax-exempt organization licensed the results of the research to a for-profit enterprise in consideration of an arm's length royalty consistent with its tax-exempt status.

This Article is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a Czech student, trainee, or researcher is entitled to the benefits of this Article even if such individual becomes a resident of the United States under the "substantial presence" test of Code section 7701(b). However, the benefits of this Article are not available to a U.S. citizen or "green card" holder.

Article 22. OTHER INCOME

This Article provides the rules for the taxation of items of income not dealt with in the other articles of the Convention. This Article deals with classes of income that are not dealt with elsewhere, such as lottery winnings, punitive damages, and cancellation of indebtedness income. The article also applies to items of income that are excluded from the other articles because of their source or some other characteristic. For example, Article 11 (Interest) addresses only the taxation of interest arising in a Contracting State. Interest arising in a third state therefore is subject to the rules of Article 22.

Paragraph 1 contains the general rule that such items of income derived by a resident of a Contracting State will be taxable only in the State of residence. This exclusive right of taxation applies irrespective of whether the residence State exercises its right to tax the income.

Paragraph 2 contains an exception to the general rule of paragraph 1 for income (other than income from real property) that is attributable to a permanent establishment or fixed base that is

or was maintained in a Contracting State by a resident of the other Contracting State. The taxation of such income is governed by the provisions of Articles 7 (Business Profits) or 14 (Independent Personal Services). Thus, in general, third-country income that is attributable to a permanent establishment maintained in the United States by a resident of the Czech Republic would be taxable by the United States.

There is an exception to the rule of paragraph 2 for income from real property, as defined in paragraph 2 of Article 6 (Income from Real Property (Immovable Property)). If a Czech resident derives income from real property located outside the United States that is attributable to the resident's permanent establishment or fixed base in the United States, only the Czech Republic and not the United States may tax that income. This special rule for foreign situs real property is consistent with the general rule, also reflected in Articles 6 and 23 (Capital), that only the situs and residence states may tax real property and real property income. Even if such property is part of the property of a permanent establishment or fixed base in a Contracting State, that State may not tax if neither the situs of the property nor the residence of the owner is in that State.

This Article is subject to the "saving" clause of paragraph 3 of Article 1 (General Scope). Thus the United States may tax the income of a Czech resident not dealt with elsewhere in the Convention if that Czech resident is a citizen of the United States.

Article 23. CAPITAL

This Article specifies the circumstances in which a Contracting State may impose tax on capital owned by a resident of the other Contracting State. Since the United States does not impose a national-level tax on capital, the only capital taxes covered by the Convention are those imposed by the Czech Republic. Thus, although the Article is drafted in a reciprocal manner, its provisions are relevant only for the imposition of Czech tax.

Paragraph 1 provides that capital represented by real property (as defined in Article 6 (Income from Real Property) (Immovable Property)) that is owned by a resident of a Contracting State and situated in the other Contracting State may be taxed in the situs state. Thus, real property owned by a U.S. resident and located in the Czech Republic may be taxed by the Czech Republic.

Paragraph 2 provides the same rule for movable property that is part of the business property of a permanent establishment or fixed base that an enterprise or resident of a Contracting State has in the other Contracting State. Thus, movable property that is part of the business property of a permanent establishment or fixed

base that a U.S. enterprise or resident maintains in the Czech Republic may be taxed in the Czech Republic.

The taxing right granted to the situs State under paragraphs 1 and 2 is not an exclusive right; in both cases, the State of residence may also tax. As noted above, the United States does not impose a capital tax. The Article does not preclude the Czech Republic, however, from imposing its capital tax with regard to real or immovable property owned by a Czech resident and located in the United States.

Paragraph 3 provides that capital represented by ships, aircraft or containers owned by a resident of one Contracting State and operated in international traffic may be taxed only in the residence State. This rule is consistent with the rule of Article 8 (Shipping and Air Transport) that addresses the income from international transportation activities.

Paragraph 4 provides that all other items of capital of a resident of a Contracting State shall be taxable only in the residence State.

Article 24. RELIEF FROM DOUBLE TAXATION

In this Article, each Contracting State undertakes to relieve double taxation by granting a foreign tax credit against its income tax for the income tax paid to the other country. Under paragraph 1, the credit granted by the United States is allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of this Article (the allowance of a credit) is retained. Thus, although the Convention provides for a foreign tax credit, the terms of the credit are determined by the provisions of the U.S. statutory credit, at the time the credit is given.

The U.S. foreign tax credit is generally limited under the Code to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code section 904(a)). Nothing in the Convention prevents the limitation of the U.S. credit from being applied on a per-country or overall basis or some variation thereof. In general, where source rules are provided in the Convention for purposes of determining the taxing rights of the Contracting States, these are consistent with the Code source rules for foreign tax credit and other purposes. Where, however, there is an inconsistency between Convention and Code source rules, the Code source rules (e.g., Code section 904(g)) will be used to determine the limits for the allowance of a credit under the Convention. (Paragraph 3 of the Article provides an exception to this general rule with respect to certain U.S. source income of U.S. citizens resident in the Czech Republic.)

Paragraph 2 provides that the Czech Republic may include in the income tax base of its residents items of income that, under the Convention, are also taxable by the United States. The Czech Republic will credit the U.S. tax paid on such income to the extent that such tax does not exceed the amount of Czech tax that is appropriate to the income.

Paragraph 3 provides a special rule for the tax treatment of U.S. citizens resident in the Czech Republic. Under this paragraph, income that may be taxed by the United States solely by reason of citizenship in accordance with the "saving" clause of paragraph 3 of Article 1 (General Scope) shall be treated as having its source in the Czech Republic to the extent necessary to avoid double taxation. This provision overrides U.S. law source rules only in those cases where U.S. law would operate to deny a foreign tax credit for taxes imposed by the Czech Republic under the provisions of the Convention on U.S. citizens resident in the Czech Republic. In no case, however, is this provision to reduce the taxes paid to the United States below the amount that would be paid if the individual were not a citizen of the United States, i.e., the U.S. tax imposed on a nonresident, non-citizen with respect to income arising in the United States.

As an example of the application of paragraph 3, consider a U.S. citizen resident in the Czech Republic who receives $200 of portfolio dividend income from United States sources and is subject to U.S. tax at 28 percent ($56) on that income. Under the provisions of Article 10 (Dividends), the United States tax on portfolio dividends paid to residents of the Czech Republic who are not U.S. citizens is limited to 15 percent ($30 in this case). Suppose the Czech Republic taxes that income of its resident at 40 percent, or $80, and grants, in accordance with the provisions of paragraph 2 of this Article, a credit for the $30 of U.S. tax imposed on the basis of source only. The net Czech tax will be $50 and the total tax $106. Thus, the total tax is higher than either of the two countries' taxes, indicating some double taxation. The United States agrees to resource enough of that dividend income to avoid double taxation, but in no case, to reduce the U.S. tax paid below the $30 it is entitled to tax at source. In this example, the U.S. will resource enough of the dividend to permit a credit of $26, thus reducing its net tax from $56 to $30. The total tax becomes $80 ($50 + 30), the higher of the two taxes, and double taxation is eliminated. (The need for such a resourcing provision arises only if the Czech tax exceeds the applicable U.S. tax **and** the Czech credit permitted under its law and the treaty is limited to the U.S. tax imposed under the treaty on residents of the Czech Republic who are not U.S. citizens.)

By reason of paragraph 4(a) of Article 1 (General Scope), Article 24 is not subject to the provisions of the "saving" clause of paragraph 3 of Article 1. Thus, the "saving" clause cannot be used to deny a Czech resident the benefit of the credits provided

for in paragraph 1 or to deny a U.S. citizen or resident the benefit of the credits provided for in paragraphs 2 and 3.

Article 25. NON-DISCRIMINATION

This Article ensures that nationals, enterprises and residents of a Contracting State will not be subject to discriminatory taxation in the other Contracting State. For this purpose, non-discrimination means providing national treatment.

Paragraph 1 provides that a national of one Contracting State may not be subject to taxation or any connected requirement in the other Contracting State that is different from or more burdensome than the taxation and connected requirements imposed upon a national of that other State in the same circumstances. A national of a Contracting State is afforded protection under this paragraph even if the national is not a resident of either Contracting State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same treatment in the Czech Republic as a Czech national who is in similar circumstances. It is understood, however, that for U.S. tax purposes, a U.S. citizen who is resident outside the United States, whether in the Czech Republic or a third country, is not in the same circumstances as a national of the Czech Republic who is a resident outside the United States, because the U.S. citizen is subject to U.S. tax on his worldwide income while the Czech national is subject to U.S. tax only on his U.S. source income.

Paragraph 2 defines the term "nationals" to mean all individuals possessing the nationality of a Contracting State and all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State. The term includes citizens of a Contracting State.

Paragraph 3 of the Article provides that a permanent establishment in a Contracting State of a resident of the other Contracting State may not be less favorably taxed in the first-mentioned State than an enterprise of that first-mentioned State that is carrying on the same activities. This provision, however, does not oblige a Contracting State to grant to a resident of the other Contracting State any tax allowances, reliefs, etc., that it grants to its own residents on account of their civil status or family responsibilities. Thus, if an individual resident in the Czech Republic owns a Czech enterprise that has a permanent establishment in the United States, in assessing income tax on the profits attributable to the permanent establishment, the United States is not obligated to allow to the Czech resident the personal allowances for himself and his family that he would be permitted to take if the permanent establishment were a sole proprietorship owned and operated by a U.S. resident.

Section 1446 of the Code imposes on any partnership with income effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the Convention, this obligation applies with respect to a Czech resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraph 2 of the Article. No distinction is made between U.S. and Czech partnerships. The requirement to withhold on the Czech but not the U.S. partner's share is not discriminatory taxation, but, like other withholding on nonresident aliens, is a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it may otherwise be difficult for the United States to enforce its tax jurisdiction. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a refund.

Paragraph 4 of the Article specifies that no provision of the Article will prevent either Contracting State from imposing the branch tax described in paragraph 6 of Article 10 (Dividends).

Paragraph 5 prohibits discrimination in the allowance of deductions. When a resident of a Contracting State pays interest or royalties or makes other disbursements to a resident of the other Contracting State, the first-mentioned Contracting State must allow a deduction for those payments in computing the taxable profits of the enterprise under the same conditions as if the payment had been made to a resident of the first-mentioned State. An exception to this rule is provided for cases where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 6 of Article 11 (Interest) or paragraph 5 of Article 12 (Royalties) apply, because all of these provisions permit the denial of deductions in certain circumstances in respect to excessive (not at arm's length) payments between related persons. The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expense.

Paragraph 5 also provides that any debts of a resident of a Contracting State to a resident of the other Contracting State are deductible in the first-mentioned Contracting State in computing taxable capital under the same conditions as if the debt had been contracted to a resident of the first-mentioned State. At present, only the Czech Republic imposes a capital tax. However, this Article also applies to taxes imposed by political subdivisions and local authorities of the Czech Republic and to state and local taxes in the United States. (See discussion of paragraph 7.) Thus, if such a tax is imposed on the value of real property net of

debt, the same deduction must be allowed with respect to debt of creditors who are residents of either Contracting State.

Paragraph 6 requires that a Contracting State not impose other or more burdensome taxation or connected requirements on a company that is a resident of that State, and that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, than the taxation or connected requirements that it imposes on similar resident companies owned by residents of the first-mentioned State. It is understood that the rules of Code section 367(e)(2) regarding liquidating distributions of appreciated property by a U.S. subsidiary to a foreign parent corporation, the provision in Code section 1446 for withholding of tax on distributions to non-U.S. partners (discussed above), and the rule of Code section 1361 under which nonresident alien individuals are ineligible to become shareholders of subchapter S corporations, do not violate the provisions of this Article.

Paragraph 7 provides that, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered), for purposes of providing nondiscrimination protection this Article applies to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof. Customs duties are not considered to be taxes for this purpose.

The "saving" clause of paragraph 3 of Article 1 (General Scope) does not apply to this Article, by virtue of the exceptions in paragraph 4(a) of Article 1. Thus, for example, a U.S. citizen who is resident in the Czech Republic may claim benefits in the United States under this Article.

Article 26. MUTUAL AGREEMENT PROCEDURE

This Article provides for cooperation between the competent authorities of the Contracting States to resolve disputes that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention. The competent authorities of the two Contracting States are identified in subparagraph 1(g) of Article 3 (General Definitions).

Paragraph 1 provides that, where a person considers that the actions of one or both Contracting States result or will result for him in taxation that is not in accordance with the Convention, he may present his case to the competent authority of his State of residence or citizenship. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the Convention. It is not necessary for a person first to have exhausted the remedies

provided under the national laws of the Contracting States before presenting a case to the competent authorities.

Paragraph 2 provides that, if the competent authority of the Contracting State to which the case is presented considers the case to have merit, and if it cannot reach a satisfactory solution unilaterally, it will seek agreement with the competent authority of the other Contracting State to avoid taxation not in accordance with the Convention. Any agreement reached under this provision is to be implemented even if implementation would be otherwise barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, time or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax.

Paragraph 3 authorizes the competent authorities to seek to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. It is intended that the competent authorities may agree, for example, to the same attribution of income, deductions, credits or allowances between a resident of one Contracting State and its permanent establishment in the other; to the allocation of income, deductions, credits or allowances between persons; or to settle a variety of conflicting applications of the Convention, including those regarding the characterization of items of income or of persons, the application of source rules to particular items of income, differences in meanings of a term, and differences in applying penalties, fines and interest. Agreements reached by the competent authorities under this paragraph need not conform to the internal law provisions of either Contracting State.

Paragraph 3 also authorizes the competent authorities to address double taxation in cases not provided for in the Convention, but with respect to taxes covered by the Convention. An example might be double taxation arising from a transfer pricing adjustment between two permanent establishments of a third-country resident, one in the United States and the other in the Czech Republic. Since no resident of a Contracting State is involved in the case, the Convention does not, by its terms, apply. The competent authorities may, nevertheless, use the authority of the Convention to seek to prevent double taxation.

Paragraph 4 authorizes the competent authorities to communicate with each other directly for these purposes. It is not necessary to communicate through diplomatic channels.

The benefits of this Article are also available to residents or citizens of either Contracting State under paragraph 4(a) of Article 1 (General Scope). Thus, rules, definitions, procedures, etc., that are agreed upon by the competent authorities under this

Article may be applied by the United States with respect to its citizens and residents, even if those rules etc. differ from the comparable Code provisions. Similarly, U.S. law may be overridden to provide refunds of tax to a U.S. citizen or resident under this Article.

Article 27. EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

This Article provides for the exchange of information between the competent authorities of the Contracting States. The information to be exchanged is that necessary for carrying out the provisions of the Convention or the domestic laws of the United States or the Czech Republic concerning the taxes covered by the Convention. For purposes of this Article, the taxes covered by the Convention include all taxes imposed at the national level. Exchange of information with respect to domestic law is authorized insofar as the taxation under those domestic laws is not contrary to the Convention. Thus, for example, information may be exchanged with respect to any national level tax, even if the transaction to which the information relates is a purely domestic transaction in the requesting State.

Paragraph 1 states that information exchange is not restricted by Article 1 (General Scope). This means that information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For example, if a third-country resident has a permanent establishment in the Czech Republic that engages in transactions with a U.S. resident, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Such information would not be routinely exchanged, but may be requested in specific cases.

Paragraph 1 also provides assurances that any information received in accordance with this Article will be treated as secret, subject to the same disclosure constraints that apply to information obtained under the laws of the requesting State. Information received may be disclosed only to persons, including courts and administrative bodies, concerned with the assessment, collection, enforcement or prosecution in respect of the taxes to which the information relates, or to persons concerned with the administration of these taxes. The information must be used by such persons in connection with these designated functions. Persons concerned with the administration of taxes, in the United States, include the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies is for use in the performance of their role in overseeing the administration of U.S. tax laws. Information received under this Article may be disclosed in public court proceedings or in judicial decisions.

Paragraph 2 explains that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures that are at variance with the laws or administrative practice of either State. Nor is either State obligated to supply information not obtainable under the laws or administrative practice of either State. Thus, there is no obligation to furnish information to the other Contracting State if either the requested State or the requesting State could not obtain such information for itself in a domestic case. There is also no obligation to disclose trade secrets or other information, the disclosure of which would be contrary to public policy. Either Contracting State may, however, at its discretion, subject to the limitations of the paragraph and its internal law, provide information that it is not obligated to provide under the provisions of this paragraph.

Paragraph 3 provides that, when information is requested by a Contracting State in accordance with this Article, the other Contracting State is obligated to obtain the requested information as if the tax in question were the tax of the requested State, even if that State has no direct tax interest in the case to which the request relates. The paragraph further provides that the requesting State may specify the form in which information is to be provided (e.g. depositions of witnesses and authenticated copies of original documents), so that the information can be used in the judicial proceedings of the requesting State. The requested State should provide the information in the form requested to the same extent that it can obtain information in that form under its own laws and administrative practices with respect to its own taxes.

Paragraph 4 provides that this Article applies to national taxes of every kind, notwithstanding the provisions of Article 2 (Taxes Covered).

Article 28. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

This Article confirms that any fiscal privileges to which members of diplomatic or consular missions are entitled under the general provisions of international law or under special agreements will apply, notwithstanding any provisions of this Convention to the contrary. This provision also applies to residents of either Contracting State, provided that they are not citizens of that State and, in the case of the United States, are not "green card" holders. (See subparagraph 4(b) of Article 1 (General Scope.)

Article 29. ENTRY INTO FORCE

This Article provides the rules for bringing the Convention into force and giving effect to its provisions. Paragraph 1 provides for the ratification of the Convention by both Contracting States and the prompt exchange of instruments of ratification.

Paragraph 2 provides that the Convention will enter into force on the date on which instruments of ratification are exchanged. Under subparagraph 2(a), the Convention will have effect with respect to taxes withheld at source for amounts paid or credited on or after the first day of the second month next following the date of entry into force. For example, if the Convention were to enter into force on December 10, 1993, the withholding rates on dividends, interest and royalties would be reduced (or eliminated) for amounts paid on or after February 1, 1994. For all other taxes, the Convention will have effect for any taxable period beginning on or after January 1 of the year in which the Convention enters into force, i.e., 1993 in the preceding example.

Article 30. TERMINATION

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of this Article. The Convention may be terminated at any time after five years from the date of its entry into force, provided that written notice has been given through diplomatic channels at least six months in advance. If such notice is given, the Convention will cease to apply in respect of taxes withheld on dividends, interest and royalties paid or credited on or after the first day of the January next following the expiration of the six-month period. The Convention will cease to apply with respect to other taxes for taxable periods beginning on or after the first day of the January next following expiration of the six-month period. Thus, for example, if notice of termination is given in July or later of a calendar year, the termination will not be effective as of the following January 1 but as of the second January 1, since the notice period must continue for at least six months.

Article 30 relates to unilateral termination by a Contracting State of the Convention. The Article does not prevent the Contracting States from entering into a new bilateral agreement that supersedes, amends or terminates provisions of the Convention, either prior to the expiration of the five-year period or without the six-month notification period.

CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE CZECH REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL

The United States of America and the Czech Republic, desiring to further expand and facilitate mutual economic relations have resolved to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, and have agreed as follows:

ARTICLE 1

General Scope

1. This Convention shall apply to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.

2. The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded:

a) by the laws of either Contracting State; or

b) by any other agreement between the Contracting States.

3. A Contracting State may tax its residents (as determined under Article 4 (Resident)) and its citizens, including former citizens, according to the laws of that State as if the Convention had not come into effect.

4. The provisions of paragraph 3 shall not affect:

a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), under paragraphs 1(b) and 4 of Article 19 (Pensions, Annuities, Alimony, and Child Support), and under Articles 24 (Relief From Double Taxation), 25 (Non-Discrimination), and 26 (Mutual Agreement Procedure); and

b) the benefits conferred by a Contracting State under Articles 20 (Government Service), 21 (Students, Trainees, Teachers and Researchers), and 28 (Diplomatic

Agents and Consular Officers), upon individuals who are neither citizens of, nor lawful permanent residents in, that State.

ARTICLE 2

Taxes Covered

1. The existing taxes to which this Convention shall apply are:

a) in the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes), and the excise taxes imposed with respect to the investment income of private foundations (hereafter referred to as "U.S. tax");

b) in the Czech Republic: the income taxes imposed by the income tax law and the tax on immovable property (real property tax) (hereafter referred to as "Czech tax").

2. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws and of any official published material

concerning the application of the Convention, including explanations, regulations, rulings, or judicial decisions.

ARTICLE 3

General Definitions

1. For the purposes of this Convention, unless the context otherwise requires:

a) the term "Contracting State" means the United States or the Czech Republic as the context requires;

b) the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other United States possession or territory. When used in a geographical sense, the term "United States" includes the territorial sea and the seabed and subsoil of the adjacent area over which the United States may exercise rights in accordance with international law and in which the laws relating to U.S. tax are in force;

c) the term "person" includes an individual, an estate, a trust, a partnership, a company, and any other body of persons;

d) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;

e) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean,

respectively, an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

f) the term "international traffic" means any transport by a ship or aircraft, except when such transport is solely between places in the other Contracting State;

g) the term "competent authority" means:

(i) in the United States, the Secretary of the Treasury or his delegate; and

(ii) in the case of the Czech Republic, the Minister of Finance or his authorized representative.

2. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 26 (Mutual Agreement Procedure), have the meaning which it has under the laws of that State concerning the taxes to which the Convention applies.

ARTICLE 4

Resident

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by

reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature.

2. a) However, the term "resident of a Contracting State" does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein;

b) In the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries; and

c) The Czech Republic shall consider a United States citizen or an alien lawfully admitted for permanent residence (a green card holder) to be a resident of the United States only if such person has a substantial presence, permanent home, or habitual abode in the United States.

3. The term "resident of a Contracting State" includes:

a) that State, a political subdivision, or a local authority thereof, and any agency or instrumentality of any such State, subdivision or authority; and

b) a pension trust or any other organization that is constituted and operated exclusively to provide

pension benefits or for religious, charitable, scientific, artistic, cultural or educational purposes and that is a resident of that State according to the laws of that State, notwithstanding that all or part of its income may be exempt from income tax under the domestic law of that State.

4. Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests);

b) if the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the

Contracting States shall settle the question by mutual agreement.

5. Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then if it is created under the laws of a Contracting State or a political subdivision thereof, it shall be deemed to be a resident of that State.

6. Where by reason of the provisions of paragraph 1 a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement and determine the mode of application of the Convention to such person.

ARTICLE 5

Permanent Establishment

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop; and

f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.

3. The term, "permanent establishment" also includes:

a) a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, but only if it lasts more than 12 months; and

b) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel, but only if activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than 9 months within any 12 month period.

A permanent establishment shall not exist in any taxable year in which the activity described in subparagraph a) or b) of this paragraph, respectively, continues for a period or periods aggregating less than 30 days in that taxable year.

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display, or delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) to e).

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person (other than an agent of an independent status to whom paragraph 6 applies) is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to

have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

ARTICLE 6

Income From Real Property (Immovable Property)

1. Income derived by a resident of a Contracting State from real property (including income from agriculture or

forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "real property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as real property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of real property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

5. A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may compute the tax on such income on a net basis as if such income were attributable to a permanent establishment in such other State. In the case of the United States tax, an election to

apply the preceding sentence shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the United States agrees to terminate the election.

ARTICLE 7

Business Profits

1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on or has carried on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on or has carried on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on or has carried on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

3. In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses that are incurred for the purposes of the permanent establishment, including a reasonable allocation of research and development expenses, interest, and other similar expenses and executive and general and administrative expenses, whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. No business profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Nothing in this Article shall affect the application of any law of a Contracting State relating to the determination of the tax liability of a person in cases where the information available to the competent authority of that State is inadequate to determine the profits to be attributed to a permanent establishment, provided that, on the basis of the available information, the determination of

the profits of the permanent establishment is consistent with the principles stated in this Article.

7. For the purposes of the Convention, the term "business profits" means income derived from any trade or business. It includes, for example, profits from manufacturing, mercantile, fishing, transportation, communication, or extractive activities, and from the furnishing of the personal services of another person, including the furnishing by a corporation of the personal services of its employees. It does not include income received by an individual for his performance of personal services either as an employee or in an independent capacity.

8. Where business profits include items of income which are dealt with separately in other Articles of the Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

ARTICLE 8

Shipping and Air Transport

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

2. For the purposes of this Article, the term "profits from the operation of ships or aircraft in international traffic" includes profits derived from the rental of ships

or aircraft on a full (time or voyage) basis. It also includes profits derived from the rental of ships or aircraft on a bareboat basis by an enterprise engaged in the operation of ships or aircraft in international traffic, if such rental activities are incidental to the activities described in paragraph 1.

3. Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers (including trailers barges, and related equipment for the transport of containers) used in international traffic shall be taxable only in that State.

4. The provisions of paragraph 1 shall also apply to profits from participation in a pool, a joint business, or an international operating agency.

ARTICLE 9

Associated Enterprises

1. Where:

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which, but for those conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be paid to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

3. The provisions of paragraph 2 shall not apply in the case of fraud, gross negligence, or willful default.

ARTICLE 10

Dividends

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 percent of the gross amount of the dividends if the beneficial owner is a company which owns at least 10 percent of the voting shares of the company paying the dividends;

b) 15 percent of the gross amount of the dividends in all other cases.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. Subparagraph a) of paragraph 2 shall not apply in the case of dividends paid by a United States Regulated Investment Company or a Real Estate Investment Trust. Subparagraph b) of paragraph 2 shall apply in the case of dividends paid by a Regulated Investment Company. In the case of dividends paid by a Real Estate Investment Trust,

subparagraph b) of paragraph 2 shall apply if the beneficial owner of the dividends is an individual holding a less than 10 percent interest in the Real Estate Investment Trust; otherwise the rate of withholding applicable under domestic law shall apply.

4. The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident. The term "dividends" also includes income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the law of the Contracting State in which the income arises.

5. The provisions of paragraph 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on or has carried on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs or has performed in that other State independent personal services from a fixed base situated therein, and the dividends are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14

(Independent Personal Services), as the case may be, shall apply.

6. A corporation which is a resident of a Contracting State may be subject in the other State to a tax in addition to the tax allowable under the other provisions of this Convention. Such tax, however, may not exceed 5 percent of the income of the corporation that is attributable to a permanent establishment in that other State or subject to tax on a net basis in that other State under Article 6 (Income from Real Property (Immovable Property)) or Article 13 (Gains), after deducting the taxes on profits imposed thereon in that other State and after adjustment for increases or decreases in the assets, net of liabilities, of the corporation connected with the permanent establishment or the trade or business. Such tax may only be applied if under the laws of that other State such tax applies with respect to any permanent establishment in that other State that is maintained by any corporation not resident in that other State.

7. Where a company that is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid forms part of the business property of a permanent

establishment or a fixed base situated in that other State, even if the dividends paid consist wholly or partly of profits or income arising in such other State.

ARTICLE 11

Interest

1. Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

2. Notwithstanding the provisions of paragraph 1, the United States may tax an excess inclusion with respect to a residual interest in a Real Estate Mortgage Investment Conduit in accordance with its domestic law.

3. The term "interest" as used in this Convention means income from debt-claims of every kind, whether or not secured by mortgage and, subject to paragraph 4 of Article 10 (Dividends), whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures, as well as all other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises.

4. The provisions of paragraph 1 shall not apply if the beneficial owner of the interest, being a resident of a

Contracting State, carries on or has carried on business in the other Contracting State, in which the interest arises, through a permanent establishment situated therein, or performs or has performed in that other State independent personal services from a fixed base situated therein, and the interest is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or fixed base, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the

payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

ARTICLE 12

Royalties

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in that other State.

2. Royalties described in subparagraph a) of paragraph 3 and beneficially owned by a resident of a Contracting State may be taxed only in that State. Royalties described in subparagraph b) of paragraph 3 may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner is a resident of the other Contracting State, the tax so charged shall not exceed 10 percent of the gross amount of the royalties.

3. The term "royalties" as used in this Convention means payments of any kind received as a consideration for the use of, or the right to use:

a) any copyright of literary, artistic or scientific work, including cinematographic films or films or tapes and other means of image or sound reproduction;

b) any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for industrial, commercial, or scientific equipment, or for information concerning industrial, commercial, or scientific experience.

The term "royalties" also includes payments derived from the disposition of any such right or property which are contingent on the productivity, use or further disposition thereof.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on or has carried on business in the other Contracting State, in which the royalties arise, through a permanent establishment situated therein, or performs or has performed in that other State independent personal services from a fixed base situated therein, and the royalties are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

5. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right, or information for which they are paid, exceeds the amount which would have been agreed upon

by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

6. For purposes of this Article:

a) Royalties shall be treated as arising in a Contracting State when the payer is that State itself or a political subdivision or local authority of that State or a person who is a resident of that State for purposes of its tax. Where, however, the person paying the royalties, whether he is a resident of one of the Contracting States or not, has in a Contracting State a permanent establishment or fixed base in connection with which the liability to pay the royalties was incurred, and the royalties are borne by the permanent establishment or fixed base, then the royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

b) Where subparagraph a) does not operate to treat royalties as arising in a Contracting State, royalties paid for the use of, or the right to use, in a Contracting State any property or right described in paragraph 3 shall be treated as arising in that State.

ARTICLE 13

Gains

1. Gains derived by a resident of a Contracting State from the alienation of real property situated in the other Contracting State may be taxed in that other State.

2. For the purposes of this Article the term "real property situated in the other Contracting State" includes real property referred to in Article 6 which is situated in that other State. It also includes shares of stock of a company the property of which consists at least 50 percent of real property situated in the other Contracting State, and an interest in a partnership, trust or estate to the extent that its assets consist of real property situated in the other State.

3. Gains from the alienation of personal (movable) property which are attributable to a permanent establishment which an enterprise of a Contracting State has or had in the other Contracting State, or which are attributable to a fixed base which is or was available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, may be taxed in that other State.

4. Gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft or containers

used in international traffic shall be taxable only in that State.

5. Payments described in paragraph 3 of Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12.

6. Gains from the alienation of any property other than property referred to in paragraphs 1 through 5 shall be taxable only in the Contracting State of which the alienator is a resident.

ARTICLE 14

Independent Personal Services

1. Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State, unless such services are performed or were performed in the other Contracting State and:

a) the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his activities; in such a case, the income attributable to that fixed base may be taxed in that other State; or

b) the individual is present in the other Contracting State for a period or periods exceeding in the aggregate 183 days in any twelve month period.

2. The term "personal services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

ARTICLE 15

Dependent Personal Services

1. Subject to the provisions of Articles 16 (Directors' Fees), 19 (Pensions, Annuities, Alimony, and Child Support), 20 (Government Service), and 21 (Students, Trainees, Teachers, and Researchers), salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period;

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration in respect of an employment as a member of the regular complement of a ship or aircraft operated by an enterprise of a Contracting State in international traffic may be taxed only in that Contracting State.

ARTICLE 16

Directors' Fees

Directors' fees and similar payments derived by a resident of a Contracting State for services rendered in the other Contracting State in his capacity as a member of the board of directors or another similar organ of a company which is a resident of the other Contracting State may be taxed in that other State.

ARTICLE 17

Limitation on Benefits

1. A person that is a resident of a Contracting State and derives income from the other Contracting State shall be

entitled under this Convention to relief from taxation in that other Contracting State only if such person is:

a) an individual;

b) a Contracting State, or a political subdivision or local authority thereof;

c) engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company) and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business;

d) a company in whose principal class of shares there is substantial and regular trading on a recognized securities exchange, or which is wholly owned, directly or indirectly, by a resident of that Contracting State in whose principal class of shares there is such substantial and regular trading on a recognized securities exchange;

e) an entity that is a not-for-profit organization (including a pension fund or private foundation) and that, by virtue of that status, is generally exempt from income taxation in its Contracting State of residence, provided that more than half of the beneficiaries, members or participants, if any, in such

organization are entitled, under this Article, to the benefits of this Convention; or

f) a person that satisfies both of the following conditions:

i) more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by persons entitled to the benefits of this Convention under subparagraphs a), b), d) or e); and

ii) not more than 50 percent of the gross income of such person is used directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to the benefits of this Convention under subparagraph a), b), d) or e).

2. A person which is not entitled to the benefits of the Convention pursuant to the provisions of paragraph 1 may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income arises so determines.

3. For purposes of subparagraph d) of paragraph 1, the term "recognized securities exchange" means:

a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock

exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934;

b) the Czech stock exchange (Burza Cennych Papiru Praha, A.S.) and any other stock exchange approved by the State authorities; and

c) any other stock exchange agreed upon by the competent authorities.

4. For purposes of subparagraph f(ii) of paragraph 1, the term "gross income" means gross receipts, or where an enterprise is engaged in a business which includes the manufacture or production of goods, gross receipts reduced by the direct costs of labor and materials attributable to such manufacture or production and paid or payable out of such receipts.

ARTICLE 18

Artistes and Sportsmen

1. Notwithstanding the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services), income derived by a resident of a Contracting State as an entertainer, such as a theater, motion picture, radio, or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the amount of the gross receipts derived

by such entertainer or sportsman, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed twenty thousand United States dollars ($20,000) or its equivalent in Czech crowns for the taxable year concerned. Such tax may be imposed by withholding upon the entire amount of all gross receipts derived by such entertainer or sportsman at any time during the taxable year concerned, provided that such entertainer or sportsman is entitled to receive a refund of such taxes when there is no tax liability for such taxable year in accordance with the provisions of this Convention.

2. Where income in respect of activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman but to another person, that income of that other person may, notwithstanding the provisions of Articles 7 (Business Profits) and 14 (Independent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised, unless it is established that neither the entertainer or sportsman nor persons related thereto participate directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions.

3. Notwithstanding the provisions of paragraphs 1 and 2, income derived by a resident of a Contracting State as an entertainer or sportsman shall be exempt from tax by the other Contracting State if the visit to that other State is substantially supported by public funds of the first-mentioned State or a political subdivision or local authority thereof or is made pursuant to a specific arrangement agreed to by the Governments of the Contracting States.

ARTICLE 19

Pensions, Annuities, Alimony, and Child Support

1. Subject to the provisions of Article 20 (Government Service):

a) pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment by that individual or another individual resident of the same Contracting State shall be taxable only in that State; and

b) social security benefits and other public pensions paid by a Contracting State to a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned State.

2. Annuities derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State. The term "annuities" as used in this paragraph means a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

3. Alimony paid to a resident of a Contracting State shall be taxable only in that State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident.

4. Nondeductible alimony and periodic payments for the support of a child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, paid by a resident of a Contracting State to a resident of the other Contracting State, shall not be taxable in that other State.

ARTICLE 20

Government Service

Remuneration, including a pension, paid from the public funds of a Contracting State or a political subdivision or local authority thereof to a citizen of that State in

respect of services rendered in the discharge of functions of a governmental nature shall be taxable only in that State. However, the provisions of Article 14 (Independent Personal Services), Article 15 (Dependent Personal Services) or Article 18 (Artistes and Sportsmen), as the case may be, shall apply, and the preceding sentence shall not apply, to remuneration paid from the public funds of a Contracting State or a political subdivision or local authority thereof in respect of services rendered in connection with a business carried on by that State, political subdivision, or local authority.

ARTICLE 21

Students, Trainees, Teachers, and Researchers

1. a) An individual who is a resident of a Contracting State at the beginning of his visit to the other Contracting State and who is temporarily present in that other Contracting State for the primary purpose of:

i) studying at a university or other accredited educational institution in that other Contracting State, or

ii) securing training required to qualify him to practice a profession or professional specialty, or

iii) studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization,

shall be exempt from tax by that other Contracting State with respect to the amounts described in subparagraph (b) of this paragraph for a period not exceeding five years from the date of his arrival in that other Contracting State.

b) The amounts referred to in subparagraph (a) of this paragraph are:

i) payments from abroad, other than compensation for personal services, for the purpose of his maintenance, education, study, research, or training;

ii) the grant, allowance, or award; and

iii) income from personal services performed in that other Contracting State in an aggregate amount not in excess of 5,000 United States dollars ($5,000) or its equivalent in Czech crowns for any taxable year.

2. An individual who is a resident of a Contracting State at the beginning of his visit to the other Contracting State and who is temporarily present in that other Contracting State as an employee of, or under contract with, a resident of the first-mentioned Contracting State, for the primary purpose of:

a) acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned Contracting State, or

b) studying at a iversity or other accredited educational institutio in that other Contracting State,

shall be exempt from tax by hat other Contracting State for a period of 12 consecutive nths with respect to his income from personal services in a aggregate amount not in excess of 8,000 United States doll s ($8,000) or its equivalent in Czech crowns.

3. An individual who a resident of one of the Contracting States at the t e he becomes temporarily present in the other Contra ing State and who is temporarily present in the ner Contracting State for a period not exceeding 1 year as a participant in a program sponsored by the Government f that other Contracting State, for the primary purpose of aining, research, or study, shall be exempt from tax by nat other Contracting State with respect to his income om personal services in respect of such training, research, r study performed in that other Contracting State in an agg gate amount not in excess of 10,000 United States dollar (USD 10,000) or its equivalent in Czech crowns.

4. The competent auth ities of the Contracting States may agree to change the amo s specified in paragraphs

1(b)(iii), 2(b), and 3 of this Article to reflect significant changes in price levels.

5. An individual who visits a Contracting State for the primary purpose of teaching or conducting research at a university, college, school or other accredited educational or research institution in the other Contracting State, and who is, or immediately before such visit was, a resident of the other Contracting State shall be exempt from tax in the first-mentioned Contracting State for a period not exceeding two years in respect of remuneration for such teaching or research. The benefits provided in this paragraph shall not be granted to an individual who, during the immediately preceding period enjoyed the benefits of one of the preceding paragraphs of this Article. An individual shall be entitled to the benefits of this paragraph only once.

6. This article shall not apply to income from research if such research is undertaken not in the public interest but primarily for the private benefit of a specific person or persons.

ARTICLE 22

Other Income

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from real property as defined in paragraph 2 of Article 6 (Income from Real Property (Immovable Property)), if the beneficial owner of the income, being a resident of a Contracting State, carries on or has carried on business in the other Contracting State through a permanent establishment situated therein, or performs or has performed in that other State independent personal services from a fixed base situated therein, and the income is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

ARTICLE 23

Capital

1. Capital represented by real property referred to in Article 6 (Income from Real Property (Immovable Property)), owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

2. Capital represented by personal (movable) property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or by personal property

pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, may be taxed in that other State.

3. Capital represented by ships, aircraft and containers owned by a resident of a Contracting State and operated in international traffic, and by personal property pertaining to the operation of such ships, aircraft, and containers shall be taxable only in that State.

4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.

ARTICLE 24

Relief From Double Taxation

1. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income the income tax paid to the Czech Republic by or on behalf of such resident or citizen.

2. In the Czech Republic, double taxation will be avoided in the following manner:

The Czech Republic, when imposing taxes on its residents, may include in the tax base upon which such taxes are imposed the items of income which according to the

provisions of this Convention may also be taxed in the United States, but shall allow as a deduction from the amount of tax computed on such a base an amount equal to the tax paid in the United States (other than solely on the basis of citizenship). Such deduction shall not, however, exceed that part of the Czech tax, as computed before the deduction is given, which is appropriate to the income which, in accordance with the provisions of this Convention, may be taxed in the United States (other than solely on the basis of citizenship).

3. In the case of an individual who is a citizen of the United States and a resident of the Czech Republic, income which may be taxed by the United States solely by reason of citizenship in accordance with paragraph 3 of Article 1 (General Scope) shall be deemed to arise in the Czech Republic to the extent necessary to avoid double taxation, provided that in no event will the tax paid to the United States be less than the tax that would be paid if the individual were not a citizen of the United States.

ARTICLE 25

Non-discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to

which nationals of that other State in the same circumstances are or may be subjected. This provision shall apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States taxation, United States nationals who are subject to tax on a worldwide basis are not in the same circumstances as Czech nationals who are not residents of the United States.

2. The term "nationals" means:

a) all individuals possessing the nationality of a Contracting State;

b) all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

4. Nothing in this Article shall be construed as preventing either Contracting State from imposing a tax as described in paragraph 6 of Article 10 (Dividends).

5. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 4 of Article 11 (Interest), or paragraph 5 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other

similar enterprises of the first-mentioned State are or may be subjected.

7. The provisions of this Article shall, notwithstanding the provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

ARTICLE 26

Mutual Agreement Procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention.

Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

ARTICLE 27

Exchange of Information and Administrative Assistance

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (General Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only

to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

3. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in

the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

4. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a Contracting State.

ARTICLE 28

Diplomatic Agents and Consular Officers

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

ARTICLE 29

Entry Into Force

1. This Convention shall be subject to ratification in accordance with the applicable procedures of each Contracting State and instruments of ratification shall be exchanged at Washington, D.C. as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:

a) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date on which the Convention enters into force;

b) in respect of other taxes, for taxable periods beginning on or after the first day of January of the year in which the Convention enters into force.

ARTICLE 30

Termination

1. This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention at any time after 5 years from the date on which the Convention enters into force, provided that at least 6 months prior notice of termination has been given through diplomatic channels. In such event, the Convention shall cease to have effect:

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
@W. Farmer Elec. #064	9/30	$5,400.55	12/31/14	5.546% Qtr.
@W. Farmer Elec. #064	9/30	$738,501.54	12/31/14	5.546% Qtr.
@W. Farmer Elec. #126	9/30	$1,168,579.35	12/31/14	5.546% Qtr.
@W. Farmer Elec. #126	9/30	$333,463.83	12/31/14	5.546% Qtr.
@W. Farmer Elec. #126	9/30	$840,205.65	12/31/14	5.546% Qtr.
@W. Farmer Elec. #126	9/30	$287,835.11	12/31/14	5.546% Qtr.
@W. Farmer Elec. #133	9/30	$14,891,256.52	12/31/14	5.546% Qtr.
@W. Farmer Elec. #133	9/30	$17,872,888.92	12/31/14	5.546% Qtr.
@W. Farmer Elec. #133	9/30	$24,809,432.61	12/31/14	5.546% Qtr.
@W. Farmer Elec. #133	9/30	$8,860,155.66	12/31/14	5.546% Qtr.
@W. Farmer Elec. #133	9/30	$25,233,560.92	12/31/14	5.546% Qtr.
@W. Farmer Elec. #133	9/30	$3,996,939.85	12/31/14	5.546% Qtr.

S/A is a Semi-annual rate: Qtr. is a Quarterly rate.
@ interest rate buydown
* maturity extension

a) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of January next following the expiration of the 6 month period;

b) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the expiration of the 6 month period.

IN WITNESS WHEREOF, the undersigned, being duly authorized thereto, have signed this Convention.

DONE at Prague, in duplicate, in the English and Czech languages, both texts being equally authentic, this Sixteenth day of September, 1993.

FOR THE UNITED STATES OF AMERICA: FOR THE CZECH REPUBLIC:

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE UNITED STATES OF AMERICA AND THE SLOVAK REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL SIGNED AT BRATISLAVA ON OCTOBER 8, 1993

This is a technical explanation of the Convention between the United States and the Slovak Republic signed on October 8, 1993 ("the Convention"). The Convention is based on the U.S. Treasury Department's draft Model Income Tax Convention, published on June 16, 1981 ("the U.S. Model"), the Model Tax Convention on Income and Capital published by the OECD in 1992 ("the OECD Model"), and other more recent U.S. income tax conventions. Although the U.S. Model has been withdrawn, and a new Model is being developed as this Technical Explanation is being prepared, the U.S. Model was the relevant Model at the time the Convention was negotiated.

The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention.

Article 1. GENERAL SCOPE

Paragraph 1 provides that the Convention is applicable to residents of the United States or Slovakia, except where the terms of the Convention provide otherwise. Under Article 4 (Resident), a person is treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of his domicile or other similar criteria, subject to certain limitations. If a person is, under those criteria, a resident of both Contracting States, a single state of residence (or no state of residence) is assigned under Article 4. These rules govern for all purposes of the Convention. Certain provisions of the Convention are also applicable, however, to persons who may not be residents of either Contracting State. Examples include Articles 20 (Government Service), 25 (Non-Discrimination) and 27 (Exchange of Information and Administrative Assistance).

Paragraph 2 is the same as the corresponding provision in the U.S. Model. Under this paragraph, the Convention may not restrict any exclusion, exemption, deduction, credit or other benefit accorded by the tax laws of the Contracting States or by any other agreement between the Contracting States. In effect, paragraph 2 provides that the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under

domestic law. Thus, a right to tax granted by the Convention to a Contracting State cannot be exercised unless the domestic law of that State also provides for such a tax.

Under the principle of paragraph 2, a taxpayer's liability to U.S. tax need not be determined under the Convention if the Code would produce a more favorable result. This does not mean, however, that a taxpayer may pick and choose among Code and Convention provisions in an inconsistent manner in order to minimize tax. For example, suppose a Slovak resident has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that earn taxable income under the Code but do not meet the permanent establishment threshold tests of the Convention. One trade or business is profitable, and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be taxable and the loss would be offset against the profits of the two profitable ventures. In this situation, the taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B.10.) If the taxpayer invokes the Code for the taxation of all three ventures, however, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

Paragraph 3 contains the traditional "saving" clause found in all U.S. treaties. Under this paragraph, each of the Contracting States may tax its own residents, citizens and former citizens, in accordance with its domestic law, notwithstanding any Convention provision to the contrary. If, for example, a Slovak resident performs independent personal services in the United States and the income from the services is not attributable to a fixed base in the United States, Article 14 (Independent Personal Services) would normally prevent the United States from taxing the income. If, however, the Slovak resident is also a citizen of the United States, the "saving" clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under normal Code rules (i.e., without regard to Code section 894(a)). Special foreign tax credit rules applicable to U.S. taxation of certain U.S. income of U.S. citizens resident in Slovakia are provided in paragraph 3 of Article 24 (Relief from Double Taxation).

"Residence," for purposes of the "saving" clause of paragraph 3, is determined under Article 4 (Resident). Thus, for example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, e.g., a "green card" holder, and is also a

resident of Slovakia under Slovak law, and the tie-breaker rules of Article 4 determine that he is a resident of Slovakia, then he will be entitled to U.S. benefits under the Convention.

Paragraph 3 also reserves the right of each Contracting State to tax certain former citizens. In the case of the United States, citizens whose loss of citizenship had as one of its principal purposes the avoidance of U.S. tax may be taxed for a period of ten years following the loss of citizenship in accordance with Code section 877.

Paragraph 4 lists several exceptions to the "saving" clause under which a Contracting State's benefits are extended to its citizens and residents. Under subparagraph a), U.S. residents and citizens are entitled to certain U.S. benefits provided under the Convention: specifically, the correlative adjustments authorized by paragraph 2 of Article 9 (Associated Enterprises); the exemption of social security benefits paid by Slovakia that is provided in paragraph 1(b) of Article 19 (Pensions, Annuities, Alimony, and Child Support); the exemption of nondeductible alimony and child support payments paid by a Slovak resident that is provided in paragraph 4 of Article 19 (Pensions, Annuities, Alimony, and Child Support); the guarantee of a foreign tax credit provided in Article 24 (Relief from Double Taxation); the nondiscrimination protection of Article 25 (Non-Discrimination) and the competent authority procedures of Article 26 (Mutual Agreement Procedure).

Under subparagraph b), certain additional benefits are available to U.S. residents who are neither U.S. citizens nor "green card" holders (such as persons who are residents under the substantial presence test of Code section 7701(b)). These are the benefits extended to employees of the Slovak Government under Article 20 (Government Service); to visiting students, trainees teachers and researchers under Article 21 (Students, Trainees, Teachers and Researchers); and to members of diplomatic and consular missions under Article 28 (Diplomatic Agents and Consular Officers).

Article 2. TAXES COVERED

This Article identifies the U.S. and Slovak taxes to which all Articles of the Convention apply. Two articles of the Convention are also applicable, however, with respect to certain taxes other than those specified in Article 2. Article 25 (Non-discrimination) applies with respect to all taxes imposed at all levels of government, including state and local governments. Article 27 (Exchange of Information and Administrative Assistance) applies with respect to all taxes imposed by a Contracting State (i.e., imposed at the national level).

In the case of the United States, the Convention generally applies to the Federal income taxes imposed by the Internal Revenue Code. Except in the cases of Articles 25 (Non-discrimination) and 27 (Exchange of Information and Administrative Assistance), however, the accumulated earnings tax and personal holding company tax (which are considered penalty taxes) are excluded from coverage, as are the social security taxes provided in Code sections 1401, 3101 and 3111. The Convention applies to the excise taxes imposed with respect to the investment income of private foundations under Code sections 4940 et seq., but does not apply (except in the case of Articles 25 and 27) with respect to the excise taxes imposed on insurance premiums paid on policies issued by foreign insurers under Code section 4371.

In the case of Slovakia, the Convention generally applies to the income taxes imposed by the Slovak income tax law and to the Slovak tax on immovable property (the real property tax). As noted above, Article 25 (Non-Discrimination) applies to all taxes imposed at all levels of government in Slovakia and Article 27 (Exchange of Information and Administrative Assistance) applies to all national level taxes imposed by Slovakia.

Under paragraph 2, the Convention will apply to any taxes that are identical or substantially similar to those enumerated in paragraph 1 and that are imposed in addition to, or in place of, the existing taxes after October 8, 1993 (the date of signature of the Convention). Paragraph 2 also provides that the U.S. and Slovak competent authorities will notify each other of significant changes in their taxation laws. This refers to changes that are of significance to the operation of the Convention. The competent authorities will also notify each other of official published materials concerning the application of the Convention. This refers to such materials as technical explanations, regulations, rulings and judicial decisions relating to the Convention.

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines a number of basic terms used in the Convention. Certain other terms are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Resident). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). The terms "dividends," "interest" and "royalties" are defined in Articles 10 (Dividends), 11 (Interest) and 12 (Royalties), respectively. The introductory language makes clear that the definitions specified in paragraph 1 apply for purposes of the Convention, and apply unless the context otherwise requires. The latter condition allows flexibility in interpretation of the treaty in order to avoid results not intended by the treaty's negotiators.

Subparagraph 1(a) defines the term "Contracting State" to mean the United States or Slovakia, depending on the context in which the term is used.

Subparagraph 1(b) defines the term "United States" to mean the United States of America. The term does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When used in a geographical sense, the "United States" includes the territorial sea and the seabed and subsoil of the adjacent area over which the United States may exercise rights in accordance with international law and in which U.S. tax law is in force. Currently, under Code section 638, U.S. tax law applies on the continental shelf only with respect to the exploration for and exploitation of mineral resources.

Subparagraph 1(c) defines the term "Slovakia" to mean the Slovak Republic.

Subparagraph 1(d) defines the term "person" to include an individual, an estate, a trust, a partnership, a company and any other body of persons. This definition conforms to the definition in the U.S. Model. Any such person may be a "resident" of a Contracting State for purposes of Article 4 (Resident) and thus entitled to the benefits of the Convention.

Subparagraph 1(e) defines the term "company" as any body corporate or any entity treated as a body corporate for tax purposes. For U.S. tax purposes, the rules of Treas. Reg. §301.7701-2 generally will apply to determine whether an entity is a body corporate. Similarly, for U.S. tax purposes, a publicly traded partnership, as defined in Code section 7704, will be treated as a company for purposes of the Convention.

Subparagraph 1(f) defines the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" to mean an enterprise carried on by a resident of the appropriate Contracting State. Thus an enterprise of a Contracting State need not be carried on in that State. It may be carried on in the other State or in a third state.

Subparagraph 1(g) defines the term "international traffic" to mean any transport by a ship or aircraft, except when such transport is solely between places within a Contracting State. The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that the transport of goods or passengers solely between New York and Chicago by a Slovak carrier (if permitted) would not be treated as international traffic, and the resulting income would not be exempt from U.S. tax under Article 8 (Shipping and Air Transport). The income would, however, be treated as business profits under Article 7 (Business Profits) and would therefore be taxable in the United States only if attributable to a U.S. permanent establishment and only on a net basis. If, however, goods or passengers are carried

by a Slovak airline from Bratislava to New York and then to Chicago, the entire trip would be international traffic. This would be true even if a Slovak carrier transferred goods at the U.S. port of entry from a ship or plane to a land vehicle, or if the overland portion of the trip in the United States were handled by an independent carrier under contract with the Slovak carrier, so long as both parts of the trip were reflected in the original bill of lading.

Subparagraph 1(h) defines the term "competent authority." The competent authorities are charged with administering the provisions of the Convention and with attempting to resolve any doubts or difficulties that may arise in interpreting its provisions. The U.S. competent authority is the Secretary of the Treasury or his delegate. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who has, in turn, delegated the authority to the Assistant Commissioner (International). With respect to interpretive issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service. In Slovakia, the competent authority is the Minister of Finance or his authorized representative.

Paragraph 2 provides that, in the application of the Convention, any term used but not defined in the Convention will have the meaning that it has under the tax law of the Contracting State whose tax is being applied. If, however, the meaning of a term cannot be readily determined under the law of a Contracting State, or if there is a conflict in meaning under the laws of the two States that creates difficulties in the application of the Convention, the competent authorities may, pursuant to paragraph 3 of Article 26 (Mutual Agreement Procedure), agree to a common meaning in order to prevent double taxation or further any other purpose of the Convention. Likewise, if the definition of a term under either paragraph 1 of Article 3 or the tax law of a Contracting State would result in a circumstance unintended by the treaty negotiators or by the Contracting States (e.g., due to a change in the statutory definition of the term since the signing date of the Convention), the competent authorities may agree to a common meaning of the term. This common meaning need not conform to the meaning of the term under the laws of either Contracting State.

Article 4. RESIDENT

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. As a general matter, only residents of the Contracting States may claim the benefits of the Convention. The Convention definition of residence is to be used only for purposes of the Convention. The fact that a person is determined to be a resident

of a Contracting State under Article 4 does not necessarily entitle a person to the benefits of the Convention. In addition to being a resident, a person must qualify for benefits under Article 17 (Limitation on Benefits).

Under paragraph 1, the determination of residence for Convention purposes looks first to a person's liability to tax as a resident under the respective taxation laws of the Contracting States. Thus a person who is liable to tax under the laws of a Contracting State by reason of his domicile, residence, place of management, place of incorporation or any other similar criterion is treated as a resident of that State. A person who, under those laws, is a resident of one Contracting State and not of the other generally need look no further.

Paragraph 2 provides several exceptions to the general rule of paragraph 1. Under subparagraph 2(a), a person who is liable to tax in a Contracting State only in respect of income from sources within that State, or capital situated therein, will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, a Slovak consular official who is posted in the United States, and who is subject to U.S. tax on U.S. source investment income but not on non-U.S. source income, would not be considered a resident of the United States for purposes of the Convention. (In most cases such an individual also would not be a U.S. resident under the Code.)

Under subparagraph 2(b), a partnership, estate or trust will be treated as a resident of a Contracting State to the extent that the income derived by the partnership, estate, or trust is subject to tax in that State as the income of a resident, whether in the hands of the partnership, estate or trust deriving the income or in the hands of its partners, beneficiaries or grantors. This rule is applied to determine the extent to which a partnership, estate or trust is entitled to Convention benefits with respect to income that it receives from the other Contracting State. Under U.S. law, a partnership (other than certain publicly traded limited partnerships and partnerships that are reclassified as associations under Treas. Reg. § 301.7701-2) is never, and an estate or trust often is not, a taxable entity. Thus, for Convention purposes, income received by a U.S. partnership need only be treated as received by a U.S. resident to the extent that it is included in the distributive share of partners who are U.S. residents (looking through any partnerships that are themselves partners). Similarly, the treatment under the Convention of income received by a U.S. trust or estate will be determined by the residence for taxation purposes of the person subject to tax on such income, which may be the grantor, the beneficiaries or the estate or trust itself, depending on the particular circumstances. A joint venture that is taxed in Slovakia as a resident enterprise will be a resident of Slovakia for Convention purposes, even if it is characterized as a partnership under U.S. law.

Under subparagraph 2(c), a U.S. citizen or a nonresident alien lawfully admitted for permanent residence (a "green card" holder) will be treated as a U.S. resident by Slovakia for purposes of the Convention only if such individual has a substantial presence, permanent home or habitual abode in the United States. Therefore, a U.S. citizen or "green card holder whose permanent home or habitual abode is not in the U.S. and not in Slovakia and who does not stay in the U.S. long enough to be a U.S. resident under code § 7701 will not be entitled to benefits under this treaty.

Under subparagraph 3(a), the two Contracting States, their political subdivisions and local authorities, and agencies and instrumentalities thereof, are to be treated as residents of those States for purposes of Convention benefits. Under subparagraph 3(b), a pension trust or any other organization that is constituted and operated exclusively to provide pension benefits or for religious, charitable, scientific, artistic, cultural or educational purposes and that, in any such case, is a resident of a Contracting State under the laws of that State is to be treated as a resident of that State for purposes of the Convention. This rule applies notwithstanding the fact that all or part of the organization's income may be exempt from income tax under the internal laws of that State.

Paragraph 4 provides a series of tie-breaker rules to determine a single State of residence for an individual who, under the laws of the two Contracting States, and thus under paragraph 1, is deemed to be a resident of both Contracting States. These rules come from the OECD Model. The first rule establishes residence where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State with which his personal and economic relations are closest, i.e., the location of his "center of vital interests." If that test is also inconclusive, or if he does not have a permanent home available to him in either State, he will be treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither of them, he will be treated as a resident of his Contracting State of citizenship. If he is a citizen of both States or of neither, the competent authorities are instructed to determine his residence by mutual agreement.

Paragraph 5 seeks to settle dual-residence issues for companies (defined in Article 3 (General Definitions) as entities treated as a body corporate for tax purposes). A company is treated as resident in the United States if it is created or organized under the laws of the United States or a political subdivision thereof. A company is treated as a resident of Slovakia if its place of registration is in Slovakia. In most cases it is expected that the place of incorporation and registration will be the same. However, in the event that a

company is a resident of both countries under their respective domestic laws, this paragraph provides that the company will be deemed to be a resident only of the State under whose laws it was created.

Paragraph 6 provides that where a person, other than an individual or a company, is a resident of both Contracting States under their respective laws, the competent authorities will establish a single country of residence by mutual agreement and determine how the Convention is to apply to such person.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment," which is relevant to several articles of the Convention. The existence of a permanent establishment in a Contracting State is necessary under Article 7 (Business Profits) for that State to tax the business profits of a resident of the other Contracting State. Articles 10 (Dividends), 11 (Interest) and 12 (Royalties) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment or fixed base that the recipient has in the source State. If the income is attributable to a permanent establishment, Article 7 (Business Profits) applies, and if the income is attributable to a fixed base, Article 14 (Independent Personal Services) applies.

Paragraph 1 provides the basic definition of the term "permanent establishment." As used in the Convention, the term means a fixed place of business through which the business of an enterprise is wholly or partly carried on. In the case of an individual, Article 14 (Independent Personal Services) uses the concept of a "fixed base," rather than a "permanent establishment," but the two concepts are considered to be parallel.

Paragraph 2 contains a list of examples of fixed places of business that constitute a permanent establishment: a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry or other place of extraction of natural resources. The use of singular nouns in this illustrative list is not meant to imply that each such place of business constitutes a separate permanent establishment. In the case of mines or wells, for example, several such places of business could constitute a single permanent establishment if the project is a whole commercially and geographically.

Subparagraph 3(a) adds that a building site or construction or installation project, or an installation or drilling rig or ship used to explore for or exploit natural resources, also constitutes a permanent establishment, but only if it lasts more than 12 months. This 12-month threshold is the same as that provided in

the U.S. and OECD models and applies separately to each individual site or project. The testing period begins when work (including preparatory work carried on by the resident) physically begins in a Contracting State. A series of contracts or projects that are interdependent both commercially and geographically are to be treated as a single project. For example, the construction of a housing development would be considered a single project even if each house is constructed for a different purchaser. Likewise, the drilling of several wells within the same geographic area or by the same resident will be considered a single permanent establishment. If the 12-month threshold is exceeded, the site or project constitutes a permanent establishment from its first day. This interpretation of the Article is based on the Commentaries to paragraph 3 of Article 5 of the OECD Model, which constitute the generally accepted international interpretation of the language in paragraph 3 of Article 5 of the Convention.

Subparagraph 3(b) provides that the furnishing of services, including consultancy services, by an enterprise through employees or other personnel will constitute a permanent establishment, but only if activities of that nature continue (whether for the same or a connected project) within the country for a period or periods aggregating more than nine months within any 12-month period. A permanent establishment is not considered to exist, however, under either subparagraph 3(a) or 3(b) in any taxable year in which the activity described in such subparagraph continues for a period or periods aggregating less than 30 days in that taxable year.

Paragraph 4 lists a number of activities that may be carried on through a fixed place of business but that, nevertheless, will not give rise to a permanent establishment. Under subparagraph 4(a), the use of facilities solely to store, display or deliver merchandise belonging to an enterprise will not constitute a permanent establishment of that enterprise. Under subparagraphs 4(b) and (c), the maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise will not give rise to a permanent establishment of the first-mentioned enterprise. Under subparagraphs 4(d) and (e), the maintenance of a fixed place of business solely for purchasing goods or collecting information for the enterprise, or for carrying out any other activity of a preparatory or auxiliary character for the enterprise (e.g., advertising, the supply of information or certain research activities), will not constitute a permanent establishment of the enterprise. Finally, under subparagraph 4(f), a combination of the activities described in paragraph 4 will not give rise to a permanent establishment.

Paragraphs 5 and 6 specify when the use of an agent will constitute a permanent establishment. Under paragraph 5, a dependent agent of an enterprise is deemed to be a permanent establishment of the enterprise if the agent has and habitually

exercises an authority to conclude contracts in the name of that enterprise. If, however, his activities are limited to those activities specified in paragraph 4 that would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the agent is not a permanent establishment of the enterprise.

Under paragraph 6, an enterprise is not deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as an independent agent.

Paragraph 7 clarifies that a company that is a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it controls, or is controlled by, a company that is a resident of that other Contracting State, or that carries on business in that other Contracting State. The determination of whether a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

Article 6. INCOME FROM REAL PROPERTY (IMMOVABLE PROPERTY)

Paragraph 1 provides the general rule that income derived by a resident of a Contracting State from real property located in the other Contracting State (including income from agriculture or forestry) may be taxed in that other State. The income may also be taxed in the State of residence. Thus the Article does not grant an exclusive taxing right to the situs State, but merely grants it the primary right to tax. The Article does not impose any limitation in terms of rate or form of tax on the situs State, except that, as provided in paragraph 5, the situs State must allow the taxpayer an election to be taxed on a net basis.

Paragraph 2 defines the term "real property" by reference to the internal law of the situs State. In addition, the paragraph specifies certain classes of property that, regardless of internal law definitions, are to be included within the meaning of the term for purposes of the Convention. The term "real property" in no event includes ships, boats or aircraft.

Paragraph 3 clarifies that all forms of income from the exploitation of real property are taxable in the situs State, including but not limited to income from direct use of real property by the owner and rental income from the letting of real property. Income from the disposition of real property, however,

is not considered to be "derived" from real property and is not covered by this Article. The taxation of such income is addressed in Article 13 (Gains). Similarly, interest paid on a mortgage on real property and distributions by a U.S. Real Estate Investment Trust are not considered to be "derived" from real property. The taxation of these items is addressed in Articles 10 (Interest) and 11 (Dividends), respectively.

Paragraph 4 clarifies that income from real property of an enterprise is covered by this Article, and not by Article 7 (Business Profits). Similarly, income from real property used for the performance of independent personal services is covered by this Article, and not by Article 14 (Independent Personal Services). Thus the situs State may tax the real property income of a resident of the other State in the absence of attribution to a permanent establishment or fixed base.

Paragraph 5 provides that a resident of one Contracting State that derives real property income from the other Contracting State may be taxed in that other State on a net basis, as if the income were attributable to a permanent establishment in that other State. For purposes of taxation by the United States, an election to be taxed on a net basis will be binding for the taxable year of the election and for all subsequent taxable years, unless the U.S. competent authority agrees to terminate the election. The election is based on the U.S. Model provision, which reflects U.S. law (Code section 871(d)).

Article 7. BUSINESS PROFITS

This Article provides the rules for the taxation by a Contracting State of the business profits of an enterprise of the other Contracting State. Paragraph 1 provides the general rule that business profits (as defined in paragraph 7) of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on or has carried on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated there. Where that condition is met, the State in which the permanent establishment is situated may tax the business profits of the enterprise, but only so much as is attributable to the assets or activity of that permanent establishment.

Paragraph 2 provides that the Contracting States will attribute to a permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. The computation of business profits attributable to a permanent establishment under this paragraph is subject to the rules of paragraph 3 for the allowance of expenses incurred for purposes of earning the income.

Profits attributable to a permanent establishment are taxable in the State where the permanent establishment is situated or was situated at the time the profits were derived. This rule incorporates the rule of Code section 864(c)(6) with respect to deferred payments, which is also reflected in the provisions of Articles 11 (Interest), 12 (Royalties), 14 (Independent Personal Services) and 22 (Other Income) dealing with amounts attributable to a permanent establishment or fixed base. If income was attributable to a permanent establishment or fixed base when earned, it is taxable by the State where the permanent establishment or fixed base was located, even if receipt of the income is deferred until the permanent establishment or fixed base has ceased to exist.

The concept of "attributable to" in paragraph 2 is analogous to, but narrower than, the concept of "effectively connected" in Code section 864(c). For example, the profits attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, Code section 864(c)(B) is consistent with paragraph 2, i.e., certain items of foreign source income described in Code section 864(c)(4)(B) may be attributed to a U.S. permanent establishment of a Slovak resident and subject to tax in the United States. The "asset use" and "business activities" tests of Code section 864(c)(2) are also consistent with the "attributable to" concept. As discussed in connection with paragraph 5, however, the limited "force of attraction" rule in Code section 864(c)(3) is not applicable under the Convention.

Paragraph 3 provides that, in determining the business profits of a permanent establishment, deductions shall be allowed for expenses that are incurred for the purposes of the permanent establishment. These include expenses directly incurred by the permanent establishment and a reasonable allocation of expenses incurred by the home office, or by other permanent establishments of the home office, as long as the expenses were incurred on behalf of the company as a whole or a part of it that includes the permanent establishment. Allocable expenses include executive and general administrative expenses, research and development expenses, interest and other similar expenses, wherever incurred and without regard to whether they are actually reimbursed by the permanent establishment.

Paragraph 4 provides that no business profits will be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent establishment that performs more than one function for the enterprise, including purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's manufacturing operation and sell the manufactured output. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are

attributable to it with respect to its purchasing activities. If the sole activity of the office were the purchasing of goods or merchandise for the enterprise, however, the issue of the attribution of income would not arise. Under subparagraph 4(d) of Article 5 (Permanent Establishment), the office would not be a permanent establishment to which profits could be attributed.

Under paragraph 5, the business profits attributed to a permanent establishment are only those profits derived from its assets or activities. This paragraph clarifies that the "limited force of attraction" concept of Code section 864(c)(3) is not incorporated into the Convention. The paragraph is also intended to assure consistent tax treatment over time for permanent establishments by providing that profits shall be determined by the same method of accounting each year, unless there is good reason to change the method used. This provision restricts both the Contracting State in changing accounting methods to be applied to permanent establishments and permanent establishments seeking to change accounting methods. This provision, however, does not restrict a Contracting State from imposing additional requirements on a permanent establishment, as provided in its law, in the event of a change in accounting method, to prevent amounts from being duplicated or omitted (see Code section 481).

Paragraph 6 provides that nothing in this Article shall affect the application of any law of a Contracting State relating to the determination of the tax liability of any person in cases where the information available to the competent authority of that State is inadequate to determine the profits to be attributed to a permanent establishment. In any such case, however, the determination of the profits of the permanent establishment must be consistent with the principles stated in this Article (to the extent possible based on the available information).

Paragraph 7 defines the term "business profits" to mean generally any income derived from any trade or business. Business profits include, specifically, income from the furnishing of the personal services of other persons, but do not include compensation received by an individual for the performance of personal service, whether as an employee or in an independent capacity. Thus a consulting firm resident in one State whose employees perform services in the other State through a permanent establishment may be taxed in that other State on a net basis under Article 7. The salaries of the employees, however, will be subject to the rules of Article 15 (Dependent Personal Services).

Paragraph 8 coordinates the provisions of this Article and other provisions of the Convention. Under paragraph 8, where business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will, except where they specifically provide to the contrary, take precedence over the provisions of Article 7.

Thus, for example, the taxation of interest will be determined by the rules of Article 11 (Interest), and not by Article 7, except where (as provided in paragraph 4 of Article 11) the interest is attributable to a permanent establishment.

This Article is subject to the "saving" clause of paragraph 3 of Article 1 (General Scope) of the Model. Thus, if a citizen of the United States who is a resident of Slovakia under the Convention derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may, subject to the special foreign tax credit rules of paragraph 3 of Article 24 (Relief from Double Taxation), tax those profits, notwithstanding the provisions of this Article.

Article 8. SHIPPING AND AIR TRANSPORT

This Article governs the taxation of profits from the operation of ships and aircraft in international traffic. Under paragraph 1, profits derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic are taxable only in that State. By virtue of paragraph 8 of Article 7 (Business Profits), profits of an enterprise of a Contracting State that are exempt in the other Contracting State under this paragraph are exempt in that other State even if the enterprise has a permanent establishment there.

Paragraph 2 defines the term "profits from the operation of ships or aircraft in international traffic" to include profits derived from the rental of ships or planes on a full (time or voyage) basis (i.e., with crew) for use in international traffic. The term also includes profits derived from the leasing of ships or aircraft on a bareboat basis (i.e., without crew) for use in international traffic, provided that the lessor is an enterprise engaged in the operation of ships or aircraft in international traffic and the profits are incidental to such activities.

Paragraph 3 provides that profits derived by an enterprise of a Contracting State from the use, maintenance or rental of containers (including trailers, barges and related equipment for the transport of containers) used in international traffic are exempt from tax in the other Contracting State. This result obtains whether the enterprise is engaged in the operation of ships or aircraft in international traffic or is a leasing company, and whether or not the enterprise has a permanent establishment in that other Contracting State.

Paragraph 4 clarifies that the provisions of paragraph 1 apply to income from participation in a pool, joint business, or international operating agency. This refers to various arrangements for international cooperation by carriers in shipping and air transport. For example, if the Slovak airline were to form

a consortium with other national airlines, the Slovak participant's share of the total income derived by the consortium from U.S. sources would be covered by this Article.

Article 9. ASSOCIATED ENTERPRISES

This Article incorporates into the Convention the general principles of Code section 482. It provides generally that when a resident of one Contracting State engages in transactions with a related person resident in the other Contracting State, and such transactions are not conducted on an arm's length basis, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such persons to reflect the income or tax liability with respect to such transactions that each person would have had if the relationship between them had been at arm's length.

Paragraph 1 deals with the circumstances where an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or when the same persons participate directly or indirectly in the management, control, or capital of an enterprise of one Contracting State and of an enterprise of the other Contracting State. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable. If, in either circumstance, the two enterprises make or impose conditions in their commercial or financial relations that differ from the conditions that would exist in relations between independent enterprises, the competent authorities may adjust the income of the related enterprises to reflect the profits that would have accrued to either enterprise if the two enterprises had been independent of each other.

Paragraph 2 provides that, where a Contracting State has made an adjustment that is consistent with the provisions of paragraph 1, the other Contracting State will make a corresponding adjustment to the tax liability of the related enterprise in that other State. It is understood that the other Contracting State need adjust its tax only if it agrees that the initial adjustment under paragraph 1 is appropriate. The Contracting State making an adjustment under this paragraph will take the other provisions of the Convention into account. For example, if the effect of a correlative adjustment is to treat a Slovak corporation as having made a distribution of profits to its U.S. parent corporation, the provisions of Article 10 (Dividends) will apply to that distribution. The competent authorities are authorized to consult, if necessary, to resolve any differences in the application of this paragraph.

Paragraph 2 of Article 26 (Mutual Agreement Procedure) explains that any correlative adjustment made under this paragraph

will be implemented, notwithstanding any time limits or procedural limitations in the law of the Contracting State making the adjustment. The "saving" clause of paragraph 3 of Article 1 (General Scope) does not apply to paragraph 2 of Article 9. Thus even if the statute of limitations has run, or there is a closing agreement between the Internal Revenue Service and the taxpayer, a refund of tax can be made in order to implement a correlative adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because, under paragraph 2 of Article 1 (General Scope), the Convention cannot restrict any statutory benefit.

Under paragraph 3, the provisions of paragraph 2 are not applicable in the case of fraud, gross negligence or willful default.

Article 10. DIVIDENDS

This Article provides rules for the taxation of dividends and similar amounts paid by a company resident in one Contracting State to a resident of the other Contracting State. The article permits full residence State taxation of such dividends and limited source State taxation. Article 10 also provides rules for the imposition of a tax on branch profits by the State of source.

Paragraph 1 preserves the residence State's general right to tax its residents on dividends paid by a company that is a resident of the other Contracting State. The same result is achieved by the "saving" clause of paragraph 3 of Article 1 (General Scope).

Paragraph 2 grants the source State the right to tax dividends paid by a company that is a resident of that State to a resident of the other Contracting State. If the beneficial owner of the dividend is a company that owns at least 10 percent of the voting shares of the company paying the dividend, the tax that may be imposed by the source State is limited to 5 percent of the gross amount of the dividend. In all other cases, the source State tax is limited to 15 percent of the gross amount of the dividend. Indirect ownership of voting shares (e.g., through tiers of corporations) and direct or indirect ownership of nonvoting shares are not considered for purposes of determining eligibility for the 5 percent direct investment dividend rate.

Paragraph 3 relaxes the limitations on source country taxation for dividends paid by a U.S. Regulated Investment Company (RIC) or Real Estate Investment Trust (REIT). A dividend paid by a RIC is subject to the 15 percent portfolio dividend rate, regardless of the percentage of voting shares of the RIC held directly by the recipient of the dividend. Generally, the reduction of the direct investment dividend rate to 5 percent is intended to relieve multiple levels of corporate taxation in cases where the recipient

of the dividend holds a substantial interest in the payor. This rationale does not justify a reduction of the rate in the case of dividends paid by RICs, because RICs do not pay corporate tax with respect to amounts distributed to their shareholders. Further, although amounts received by a RIC may have been subject to U.S. corporate tax (e.g., dividends paid by a publicly traded U.S. company to a RIC), it is unlikely that a 10 percent shareholding in a RIC by a Slovak resident will correspond to a 10 percent shareholding in the entity that has paid U.S. corporate tax (e.g., the publicly traded U.S. company). Thus, in the case of dividends received by a RIC and paid out to its shareholders, the requirement of a substantial shareholding in the entity paying the corporate tax is generally lacking.

In the case of a dividend paid by a U.S. REIT to a Slovak resident, the U.S. statutory rate i.e., 30 percent, generally applies (except in the case of amounts subject to tax as effectively connected income under Code section 897(h)). Dividends beneficially owned by an individual holding a less than 10 percent interest in the REIT are eligible, however, for the 15 percent portfolio dividend rate provided in paragraph 3. The denial of the 15 percent portfolio rate to corporate shareholders and 10 percent or greater individual shareholders is intended to prevent indirect investment in U.S. real property through a REIT from receiving more favorable treatment than direct investment in such real property.

Paragraph 4 defines the term "dividends," as used in this Article, to include income from any shares, "jouissance" rights, mining shares, founders' shares or other rights that are not debt claims and that participate in profits; income from other corporate rights that is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making a distribution is a resident; and income from arrangements, including debt obligations, if such arrangements carry the right to participate in profits and the income is characterized as a dividend under the domestic law of the Contracting State in which the income arises.

Paragraph 5 provides that, where dividends are attributable to a permanent establishment or fixed base that the beneficial owner maintains in the country of source, they are not subject to the provisions of paragraph 2 of this Article, but instead are taxable under Article 7 (Business Profits) or Article 14 (Independent Personal Services), as appropriate. Such dividends will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the Contracting State in which the permanent establishment or fixed base is located, as modified by the Convention.

Paragraph 6 permits a Contracting State to impose a "branch profits tax" on a corporation that is a resident of the other State. Under paragraph 6, a Contracting State may impose a tax, in

addition to other taxes permitted by the Convention, on a corporation that is a resident of the other Contracting State and that maintains a permanent establishment in the first mentioned State or that is subject to net basis taxation in that State under Article 6 (Income from Real Property (Immovable Property)) or Article 13 (Gains). The additional tax may not exceed 5 percent of the income of the corporation that is attributable to a permanent establishment in the taxing State or subject to tax on a net basis in that State, after deducting the taxes on profits imposed thereon in that other State and after adjustment for increases or decreases in the assets, net of liabilities, of the corporation connected with the permanent establishment or the trade or business. Such tax may only be imposed if, under the domestic law of the taxing State, it applies to the permanent establishment of any nonresident corporation. The U.S. tax will be imposed in accordance with Code section 884, subject to the limitation provided for in this Article. For U.S. tax purposes, the limitation is understood to correspond to 5 percent of the "dividend equivalent amount," as defined in Code section 884.

Under paragraph 7, where a company that is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid forms part of the business property of a permanent establishment or a fixed base situated in that other State. This result obtains even if the dividends paid consist wholly or partly of profits or income arising in such other State.

Article 11. INTEREST

Paragraph 1 grants to each Contracting State the exclusive right (subject to paragraphs 2 and 4) to tax interest beneficially owned by a resident of that Contracting State and arising in the other Contracting State.

Paragraph 2 reserves the right of the United States to tax an excess inclusion of a residual holder of a Real Estate Mortgage Investment Conduit (REMIC) in accordance with its law. Thus, the tax on such an excess inclusion of a Slovak resident would be subject to the U.S. statutory rate of withholding tax, i.e., 30 percent.

Paragraph 3 defines the term "interest," as used in the Convention, to include income from debt claims of every kind, whether or not secured by a mortgage, and, subject to paragraph 4 of Article 10 (Dividends), whether or not carrying a right to participate in profits. The term "interest" includes, in particular, income from government securities, income from bonds or

debentures, and any premiums or prizes attaching to such securities, bonds or debentures, and all other income treated as interest by the taxation law of the source State. The definition does not refer to penalties and fines for late payment, which are frequently excluded from the treaty definition of interest. However, such amounts would also be exempt from tax at source under Article 22 (Other Income).

Paragraph 4 provides an exception from the rule of paragraph 1 in cases where the beneficial owner of the interest, who is a resident of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed based situated in that other State and the interest is attributable to that permanent establishment or fixed base. In such a case, the income is taxable to the permanent establishment or fixed base in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services). This rule applies even if the permanent establishment or fixed base no longer exists when the interest is received or accrued, as long as the interest would have been attributable to the permanent establishment or fixed base if it had been received or accrued in the earlier year, i.e., because the debt claim on which the interest is paid was attributable to the permanent establishment in such earlier year.

Paragraph 5 provides a source rule for interest. Under this paragraph, interest is deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the payer (whether or not a resident of a Contracting State) has in a Contracting State a permanent establishment or fixed base, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

Paragraph 6 provides that if, as a result of a special relationship between the payer and the beneficial owner of the interest, or between both of them and some other person, the interest paid is excessive, Article 11 applies only to the amount of interest payments that would have been made absent such special relationship (i.e., an arm's length interest payment). Any excess amount of interest paid remains taxable according to the laws of the United States and Slovakia, respectively, with due regard to the other provisions of the Convention. Thus, for example, if the excess amount would be treated as a distribution of profits, such amount could be taxed as a dividend, rather than as interest, subject to the provisions of Article 10 (Dividends).

Because the rule of paragraph 2 provides for exemption at source of interest derived by a resident of the other Contracting State, the United States will not impose tax under Code section 884 on excess interest of a U.S. branch of a Slovak company.

Article 12. ROYALTIES

Paragraph 1 grants to each Contracting State the right (subject to paragraph 2, discussed below) to tax royalties beneficially owned by its residents and arising in the other Contracting State.

Paragraph 3 defines the term "royalties" as used in the Convention. Under subparagraph 3(a), the term "royalties" includes payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematographic films or films or tapes and other means of image or sound reproduction. The reference to "other means" of reproduction makes clear that subsequent technological advances will not affect the exclusion of payments relating to the use of such means of image or sound reproduction from the definition of royalties. Under subparagraph 3(b), the term also includes payments for the use of, or right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for industrial, commercial, or scientific equipment or for information concerning industrial, commercial, or scientific experience. In addition, the term "royalties" includes gains from the alienation of any right or property described in paragraph 3 that is contingent on the productivity, use, or further disposition of the property.

Under paragraph 2, royalties described in subparagraph 3(a) ("copyright royalties") that are paid by a resident of one Contracting State and beneficially owned by a resident of the other Contracting State are taxable only in that other Contracting State, i.e., the residence State of the beneficial owner. The scope of the term "copyright" as used in the paragraph is determined under domestic law. Royalties described in subparagraph 3(b) ("industrial royalties") may be taxed both by the source State and by the residence State of the beneficial owner, but the tax that may be imposed by the source State is limited to 10 percent of the gross amount of the royalties. Taxation of any royalties arising in one Contracting State and derived and beneficially owned by a resident of the other Contracting State is a departure from the U.S. model. Inclusion of equipment rentals under the definition of royalties is a further departure from the U.S. model. However, like a number of countries, Slovakia feels strongly about this point and the maximum treaty rate of 10% does represent a significant reduction of the Slovak nontreaty rate of 25%.

Paragraph 4 provides an exception to the rules of paragraphs 1 and 2 in cases where a beneficial owner of royalties who is a resident of one Contracting State carries on or has carried on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base in that other State and the royalties are attributable to that permanent establishment or fixed base, i.e., the right or property

in respect of which the royalties are paid forms part of the business property of such permanent establishment or fixed base. In such a case, the royalties are taxable in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), and the source State will generally retain the right of taxation. This rule applies even if the permanent establishment or fixed base no longer exists when the royalties are paid or accrued, as long as the royalties would have been attributable to the permanent establishment or fixed base if they had been paid or accrued in the earlier year, e.g., because the license in respect of which the royalties are paid was attributable to the permanent establishment in such earlier year.

Paragraph 5 provides that if, as a result of a special relationship between the payer and the beneficial owner of a royalty, or between both of them and some other person, the royalty paid is excessive, Article 12 applies only to the amount of the royalty payment that would have been made absent such special relationship (i.e., an arm's length royalty payment). Any excess amount of royalty paid remains taxable according to the laws of the United States and Slovakia, respectively, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of profits by a company under the internal law of the source State, such excess amount will be taxed as a dividend, rather than as a royalty payment, subject to the provisions of Article 10 (Dividends).

Paragraph 6 provides source rules for royalty payments. Under subparagraph 6(a), royalties are treated as arising in a Contracting State when the payer is that State itself, a political subdivision or local authority of that State or a person who is a resident of that State for purposes of its tax. Where, however, the person paying the royalties (whether or not a resident of one of the Contracting States) has in a Contracting State a permanent establishment or fixed base in connection with which the liability to pay royalties was incurred, and the royalties are borne by the permanent establishment or fixed base, then the royalties are deemed to arise in the State in which the permanent establishment or fixed base is situated. Where subparagraph 6(a) does not apply to treat royalties as arising in a Contracting State, subparagraph 6(b) treats royalties paid for the use of, or the right to use, any property or right described in paragraph 3 in a Contracting State as arising in that State.

Article 13. GAINS

This Article provides rules for source and residence State taxation of gains from the alienation of property.

Paragraph 1 provides that gains derived by a resident of one Contracting State from the alienation of real property situated in

the other Contracting State may be taxed in the other (situs) State. This paragraph is intended to preserve the right of the United States to tax the full range of gains taxable under section 897 of the Code.

For purposes of Article 13, paragraph 2 defines the term "real property situated in the other Contracting State" to include real property referred to in Article 6 (Income from Real Property (Immovable Property)) (i.e., interests in the immovable property itself) and certain indirect interests in real property. Such indirect interests include shares of stock in a company at least 50 percent of the assets of which consist of real property situated in the source State. Thus, a Slovak resident would be subject to U.S. tax on gain from the alienation of shares in a United States Real Property Holding Corporation. Similarly, such a resident would be subject to tax on a liquidating distribution by such a U.S. corporation and on a distribution by a REIT attributable to gain from the alienation of U.S.-situs real property. This provision also preserves the U.S. right to tax gain from the alienation of an interest in a partnership, trust or estate, to the extent that the gain is attributable to U.S.-situs real property.

Paragraph 3 preserves the right of the source State to tax gains from the alienation of personal (movable) property in certain circumstances. Under paragraph 3, gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State, or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

Paragraph 4 provides that gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft or containers used in international traffic are taxable only in that State.

Paragraph 5 clarifies that payments described in paragraph 3 of Article 12 (Royalties), including gains from the alienation of any right or property described in paragraph 3 of Article 12 that is contingent on the productivity, use, or further disposition of the property, are taxable only in accordance with the provisions of Article 12.

Paragraph 6 grants to the residence State the exclusive right to tax gains from the alienation of property other than property referred to in paragraphs 1 through 5.

Article 14. INDEPENDENT PERSONAL SERVICES

The Convention deals in separate articles with different classes of income from personal services. Article 14 deals with the general class of income from independent personal services, and Article 15 deals with the general class of income from employment (dependent personal services). Exceptions and additions to these general rules are provided for directors' fees in Article 16; for performance income of artistes and sportsmen in Article 18; for pensions in respect of personal service income and social security benefits in Article 19; for government service salaries and pensions in Article 20; and for certain income of students, trainees, teachers and researchers in Article 21.

Under paragraph 1, income derived by an individual who is a resident of one Contracting State from the performance of personal services in an independent capacity in the other Contracting State is exempt from tax in that other State unless the services are or were performed in that other State (see Code section 864(c)(6)) and either (a) the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his services, in which case the income attributable to that fixed base may be taxed in that other State, or (b) the individual remained in that other State for more than an aggregate of 183 days in any twelve month period. The State of residence may tax in either case under paragraph 3 of Article 1 (General Scope). In addition, under paragraph 3 of Article 1 (General Scope), if the individual is a Slovak resident who performs independent personal services in the United States, and the individual is also a U.S. citizen, the United States may tax his income without regard to the restrictions of this Article, subject to the special foreign tax credit rules of paragraph 3 of Article 24 (Relief from Double Taxation).

The term "fixed base" is not defined in the Convention, but its meaning is understood to be analogous to that of the term "permanent establishment." Therefore, it is understood that the income attributed to a fixed base will be taxed in accordance with principles similar to those provided in Article 7 (Business Profits) for the taxation of business enterprises. However, in this case, only income from services performed in a Contracting State may be attributed to a fixed base in that State.

Paragraph 2 notes that the term "personal services" includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list, which is derived from the OECD Model, is not exhaustive. The term includes all personal services performed by an individual for his own account, where he receives the income and bears the risk of loss arising from the services. The taxation of income from the

types of independent services that are covered by Articles 16 and 18 through 21 is governed by the provisions of those articles.

Article 15. DEPENDENT PERSONAL SERVICES

This Article deals with the taxation of remuneration derived by a resident of a Contracting State for the performance of personal services in the other Contracting State as an employee.

Under paragraph 1, remuneration derived by an employee who is a resident of a Contracting State may be taxed by his State of residence. This is the same result as achieved by paragraph 3 of Article 1 (General Scope). However, to the extent that the remuneration is derived from an employment exercised (the performance of services) in the other Contracting State, the remuneration also may be taxed by that other Contracting State unless the conditions specified in paragraph 2 are satisfied.

Paragraph 1 also provides that the more specific rules of Articles 16 (Directors' Fees), 19 (Pensions, Annuities, Alimony, and Child Support), 20 (Government Service), and 21 (Students, Trainees, Teachers, and Researchers) apply in the case of employment income described in one of these articles. Thus, even though the State of source has a general right to tax employment income under Article 15, it may not have the right to tax a particular type of income under the Convention if that right is proscribed by one of the aforementioned articles. Similarly, though a State of source may have no general right of taxation under Article 15 with respect to a particular item of income, the State may have the right to tax that income under one of the aforementioned Articles.

Under paragraph 2, remuneration of an individual resident of a Contracting State that is derived from the performance of services as an employee within the other Contracting State may not be taxed by that other Contracting State if three conditions are satisfied: (a) the individual is present in that State for a period or periods not exceeding in the aggregate 183 days in any twelve month period; (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other Contracting State; and (c) the remuneration is not borne by a permanent establishment or fixed base that the employer has in that other State. If a foreign employer pays the salary of an employee, but a host country corporation or permanent establishment reimburses the foreign employer in a deductible payment that can be identified as a reimbursement, neither condition (b) nor (c) will be considered to have been fulfilled. Conditions (b) and (c) are intended to ensure that a Contracting State will not be required both to allow a deduction to the payor for the amount paid and to exempt the employee on the amount received. In order for the remuneration to

be exempt from tax in the source State, all three conditions must be satisfied.

Paragraph 3 contains a special rule applicable to remuneration for services performed by an individual who is a resident of a Contracting State as an employee aboard a ship or aircraft operated in international traffic. Such remuneration may be taxed only in the Contracting State of residence of the employee if the services are performed as a member of the regular complement of the ship or aircraft. This rule is similar to the corresponding provision in the U.S. Model. The "regular complement" of a ship or aircraft includes the crew. In the case of a cruise ship, it may also include others, such as entertainers, lecturers, etc., employed by the shipping company to serve on the ship. The use of the term "regular complement" is intended to clarify that a person who exercises his employment as, for example, an insurance salesman while aboard a ship or aircraft is not covered by this paragraph.

If a U.S. citizen who is resident in Slovakia performs dependent services in the United States and meets the conditions of paragraph 2, or is a crew member on a Slovak ship or airline, and would therefore be exempt from U.S. tax if he were not a U.S. citizen, he is nevertheless taxable in the United States on his remuneration by virtue of the saving clause of paragraph 3 of Article 1 (General Scope), subject to the special foreign tax credit rules of paragraph 3 of Article 24 (Relief from Double Taxation).

Article 16. DIRECTORS' FEES

This Article provides that a Contracting State may tax the fees paid by a company that is a resident of that State for services performed by a resident of the other Contracting State in his capacity as a director of the company, provided that the services are performed in the first-mentioned State. This rule is an exception to the more general rules of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services). Thus, for example, in determining whether a non-employee director's fee is subject to tax in the State of residence of the company, whether the company constitutes a fixed base of the director in that State is not relevant.

The rule provided in this Article represents a departure from the U.S. Model, which treats a corporate director in the same manner as any other individual performing personal services -- outside directors would be subject to the provisions of Article 14 (Independent Personal Services) and inside directors would be subject to the provisions of Article 15 (Dependent Personal Services). The preferred Slovak position is reflected in the OECD Model, in which a resident of one Contracting State who is a

director of a company that is resident in the other Contracting State is subject to tax in that other State in respect of his directors' fees regardless of where the services are performed. The provision in Article 16 of the Convention represents a compromise between these two positions. The State of residence of the company may tax nonresident directors with no threshold, but only with respect to remuneration for services performed in that State.

This Article is subject to the "saving" clause of paragraph 3 of Article 1 (General Scope). Thus, if a U.S. citizen who is a Slovak resident is a director of a U.S. corporation, the United States may tax his full remuneration regardless of the place of performance of his services.

Article 17. LIMITATION ON BENEFITS

Article 17 ensures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State -- and are not extended to residents of third States not having a substantial business in, or business nexus with, the other Contracting State. For example, a resident of a third State might establish an entity resident in a Contracting State for the purpose of deriving income from the other Contracting State and claiming source State benefits with respect to that income. Absent Article 17, the entity would generally be entitled to benefits as a resident of a Contracting State, subject to such limitations, e.g., business purpose, substance-over-form, step transaction or conduit principles, as may be applicable to the transaction or arrangement under the domestic law of the source State.

Article 17 is more detailed than the corresponding article in the U.S. Model and follows the form of the article used in more recent treaties. See, e.g., Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes. The structure of the Article is as follows: Paragraph 1 lists a series of attributes of a resident of a Contracting State, any one of which will entitle that person to benefits of the Convention in the other Contracting State. Paragraph 2 provides that benefits also may be granted to a person not entitled to benefits under the tests of paragraph 1, if the competent authority of the source State determines that it is appropriate to provide benefits in that case. Paragraph 3 defines the term "recognized securities exchange" as used in subparagraph 1(c). Paragraph 4 defines the term "gross income" as used in subparagraph 1(e)(ii).

The first two categories of persons eligible for benefits from the other Contracting State under the Convention are individual

residents of a Contracting State (subparagraph 1(a)) and the two Contracting States and their political subdivisions or local authorities (subparagraph 1(b)). It is considered unlikely that persons falling into these two categories can be used improperly to derive treaty benefits on behalf of a third-country resident. If an individual is receiving income as a nominee on behalf of a third-country resident, benefits will be denied with respect to those items of income under the articles of the Convention that grant the benefit, because of the requirements in those articles that the beneficial owner (and not merely the recipient) of the income be a resident of a Contracting State.

The third category, described in subparagraph 1(c), consists of persons that are residents of one Contracting State and derive income from the other Contracting State that is connected with, or incidental to, an active trade or business conducted in the residence State. Income that is derived in connection with, or is incidental to, the business of making or managing investments will not qualify for benefits under this provision, unless the business is a bank or insurance company engaged in banking or insurance activities. The first six examples in the Memorandum of Understanding Regarding the Scope of the Limitation on Benefits Article in the Convention Between the Federal Republic of Germany and the United States of America (German Convention) illustrate the situations covered by subparagraph 1(c).

The fourth category, described in subparagraph 1(d), consists of companies in whose principal class of shares there is substantial and regular trading on a recognized securities exchange (as defined in paragraph 3) and companies that are wholly owned, directly or indirectly, by a company that is a resident of the same Contracting State and whose principal class of shares are so traded.

The fifth category, described in subparagraph 1(e), includes not-for-profit organizations (including a pension fund or private foundation) that satisfy two conditions: (a) the organization is generally exempt from tax in its State of residence by virtue of its not-for-profit status and (b) more than half of the beneficiaries, members, or participants, if any, in the organization are persons who are entitled under this Article to benefits of the Convention.

The sixth category, described in subparagraph 1(f) of paragraph 1, includes persons who satisfy two tests: the so-called "ownership" and "base erosion" tests. The "ownership" test requires that more than 50 percent of the beneficial interest in the person (or, in the case of a company, more than 50 percent of each class of its shares) be owned, directly or indirectly, by persons who are themselves entitled to benefits under the other tests of paragraph 1 (other than subparagraph c)). The "base erosion" test requires that not more than 50 percent of the

person's gross income (as defined in paragraph 4) be used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to benefits under the other tests of paragraph 1 (other than subparagraph c)).

The rationale for the two-part test of subparagraph 1(f) derives from the fact that treaty benefits can be indirectly enjoyed not only by equity holders of an entity, but also by that entity's various classes of obligees, such as lenders, licensors, service providers, insurers and reinsurers, and others. In order to prevent such benefits from inuring substantially to third-country residents, it is not sufficient merely to require substantial ownership of the entity by treaty country residents or their equivalent. It is also necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or their equivalents. For example, a third-country resident could lend funds to a Slovak-owned Slovak corporation to be reloaned to the United States. The U.S. source interest income of the Slovak corporation would be exempt from U.S. withholding tax under Article 11 (Interest) of the Convention. While the Slovak corporation would be subject to Slovak income tax, its taxable income could be reduced to near zero by the deductible interest paid to the third-country resident. If, under a Convention between Slovakia and the third country, that interest is exempt from Slovak tax, the U.S. treaty benefit with respect to the U.S. source interest income will have flowed to the third-country resident.

It is intended that the provisions of paragraph 1 will be self-executing. Unlike the provisions of paragraph 2, discussed below, a claim of benefits under paragraph 1 does not require advance competent authority ruling or approval. The tax authorities may, of course, determine on review that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

Paragraph 2 of Article 17 permits the competent authority of the State in which income arises to grant Convention benefits in additional cases, even if they do not meet the standards of paragraph 1 (or sufficient information is not available to make such a determination). This discretionary provision is included in recognition that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third-country residents in an enterprise of a Contracting State is warranted by sound business practice and does not indicate a motive of attempting to derive unintended Convention benefits.

Paragraph 3 defines the term "recognized securities exchange" as used in subparagraph 1(d). In the case of the United States, this term means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with

the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934. In the case of Slovakia, the term means the Slovak stock exchange (Burza Cennych Papierov Bratislava A.S.) and any other stock exchange approved by the Slovak State authorities. The term "recognized securities exchange" also includes any other stock exchange located in a Contracting State and agreed upon by the competent authorities.

Paragraph 4 defines the term "gross income," as used in subparagraph 1(e)(ii), generally to mean gross receipts. In the case of an enterprise engaged in a manufacturing or production business, the term "gross income" means gross receipts reduced by the direct costs of labor and materials attributable to such manufacture or production and paid or payable out of such receipts.

Article 18. ARTISTES AND SPORTSMEN

Article 18 addresses the taxation in a Contracting State of artistes (i.e., performing artists and entertainers) and athletes resident in the other Contracting State from the performance of their services as such. The Article applies both to the income of an entertainer or athlete who performs services on his own behalf and one who performs his services on behalf of another person, either as an employee of that person or pursuant to any other arrangement. The rules of this Article take precedence over those of Article 14 (Independent Personal Services) and 15 (Dependent Personal Services). This Article applies, however, only with respect to the income of performing artists and athletes. Others involved in a performance or athletic event, such as producers, directors, technicians, managers, coaches, etc., remain subject to the provisions of Articles 14 and 15.

Paragraph 1 describes the circumstances in which a Contracting State may tax the performance income of an entertainer or athlete who is a resident of the other Contracting State. Under the paragraph, income derived by a resident of a Contracting State from his personal activities as an entertainer or athlete exercised in the other Contracting State may be taxed in that other State if the amount of the gross receipts derived by the individual exceeds $20,000 (or its equivalent in Slovak crowns) for the taxable year concerned. The $20,000 includes expenses reimbursed to the individual or borne on his behalf. If the gross receipts exceed $20,000, the full amount, not just the excess, may be taxed in the State of performance.

The OECD Model provides for taxation by the country of performance of the remuneration of entertainers with no dollar or time threshold. The United States introduces the dollar threshold test to distinguish between two groups of entertainers and athletes -- those who are paid very large sums of money for very short

periods of service, and who would, therefore, normally be exempt from host country tax under the standard personal services income rules, and those who earn only modest amounts and are, therefore, not clearly distinguishable from those who earn other types of personal service income.

Paragraph 1 applies notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services) or 15 (Dependent Personal Services). Thus, if an individual would otherwise be exempt from tax under those Articles, but is subject to tax under this Article, he may be taxed. An entertainer or athlete who receives less than the $20,000 threshold amount, and who is, therefore, not affected by this Article, may nevertheless be subject to tax in the host country under Article 14 or 15 if the tests for taxability under those Articles are met. For example, if an entertainer who is an independent contractor earns only $19,000 of income for the calendar year, but the income is attributable to a fixed base regularly available to him in the State of performance, that State may tax his income under Article 14. It is frequently not possible to know until year end whether the income and entertainer or athlete derived from performance in a Contracting State will exceed $20,000. Nothing in the Convention precludes that Contracting State, however, from withholding tax during the year and refunding after the close of the year if the taxability threshold has not been met.

Paragraph 2 is intended to deal with the potential for abuse when income from a performance by an entertainer or athlete does not accrue to the performer himself, but to another person. Foreign entertainers commonly perform in the United States as employees of, or under contract with, a company or other person. The relationship may truly be one of employee and employer, with no abuse of the tax system either intended or realized. On the other hand, the "employer" may be, for example, a company established and owned by the performer that is merely acting as the nominal income recipient in respect of the remuneration for the performer's performance. The performer may be acting as an "employee," receiving a modest salary and arranging to receive the remainder of the income from his performance in another form or at a later time. In such a case, absent the provisions of paragraph 2, the company providing the entertainer's services can escape host country tax because it earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host country tax by receiving only a small salary in the year the services are performed, perhaps small enough to place him below the dollar threshold in paragraph 1. He would arrange to receive further payments in a later year, when he is not subject to host country tax, perhaps as salary payments, dividends, or liquidating distributions.

Paragraph 2 seeks to prevent this type of abuse while at the same time protecting the taxpayers' rights to the benefits of the

Convention when there is a legitimate employee-employer relationship between the performer and the person providing his services. Under paragraph 2, when the income accrues to a person other than the performer, and the performer (or persons related to him) participate, directly or indirectly, in the profits of that other person, the income may be taxed in the Contracting State where the performer's services are exercised, without regard to the provisions of the Convention concerning business profits (Article 7) or independent personal services (Article 14). Thus, even if the "employer" has no permanent establishment or fixed base in the host country, its income may be subject to tax there under the provisions of paragraph 2. Taxation under paragraph 2 is on the person providing the services of the entertainer or athlete. This paragraph does not affect the rules of paragraph 1, which apply to the entertainer or athlete himself. To the extent of salary payments to the performer, which are treated under paragraph 1, the income taxable by virtue of paragraph 2 to the person providing his services is reduced.

For purposes of paragraph 2, income is deemed to accrue to another person (i.e., the person providing the services of the entertainer or athlete) if that other person has control over, or the right to receive, gross income in respect of the services of the entertainer or athlete. Direct or indirect participation in the profits of a person may include, but is not limited to, the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income or other income or distributions.

The paragraph 2 override of the protection of Articles 7 (Business Profits) and 14 (Independent Personal Services) does not apply if it is established that neither the entertainer or athlete, nor any persons related to the entertainer or athlete, participate directly or indirectly in the profits of the person providing the services of the entertainer or athlete. Thus, for example, if a circus owned by a U.S. corporation performs in Bratislava, the Slovak promoters of the performance pay the circus, which in turn pays salaries to the clowns. The circus has no permanent establishment in Slovakia. Since the clowns do not participate in the profits of the circus, but merely receive their salaries out of the circus' gross receipts, the circus is protected by Article 7 and its income is not subject to Slovak tax. Whether the salaries of the clowns are subject to Slovak tax depends on whether they exceed the $20,000 threshold in paragraph 1. This exception for non-abusive cases to the paragraph 2 override of the Articles 7 and 14 protection of persons providing the services of entertainers and athletes is not found in the OECD Model. The policy reflected in this exception is, however, consistent with the stated intent of Article 17 of that Model, as indicated in its Commentaries. The Commentaries to Article 17 state that paragraph 2 is intended to counteract certain tax avoidance devices in which income is diverted from the performer to another person in order to minimize

the total tax on the remuneration. It is therefore consistent not to apply these rules in non-abusive cases.

Paragraph 3 is not found in the U.S. or OECD Models. It provides an exception to the rules in paragraphs 1 and 2 in the case of a visit to a Contracting State by an entertainer or athlete who is a resident of the other Contracting State, if the visit is substantially supported, directly or indirectly, by the public funds of his State of residence or of a political subdivision or local authority of that State. In the circumstances described, only the Contracting State of residence of the entertainer or athlete may tax his income from the performances so supported in the other State.

This Article is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope). Thus, if an entertainer or athlete who is a resident in Slovakia is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of this Article, subject, however, to the special foreign tax credit provisions of paragraph 3 of Article 24 (Relief from Double Taxation).

Article 19. PENSIONS, ANNUITIES, ALIMONY, AND CHILD SUPPORT

This Article deals with the taxation of private and public pensions and annuities, alimony and child support payments.

Paragraph 1 provides in subparagraph a) that pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment may be taxed only by the State of residence of the beneficial owner. The past employment need not have been exercised by the beneficial owner of the pension. For example, a pension paid to a surviving spouse who is a resident of Slovakia would be exempt from tax by the United States on the same basis as if the right to the pension had been earned directly by the surviving spouse. A pension may be paid in installments or in a lump sum.

Subparagraph 1(b) provides that social security benefits and other public pensions paid by a Contracting State to a resident of the other Contracting State or a citizen of the United States may be taxed only by the paying State. This rule applies to benefits paid under the social security legislation of both Contracting States and certain U.S. Railroad Retirement benefits.

The rule of subparagraph 1(b) is an exception to the "saving" clause of paragraph 3 of Article 1 (General Scope). Thus, a Slovak social security benefit will be exempt from U.S. tax even if the beneficiary is a U.S. resident or a U.S. citizen (whether resident in the United States, Slovakia, or a third country). The rules of

paragraph 1 do not apply to pensions for governmental service, which are dealt with in Article 20 (Government Service).

Under paragraph 2, annuities that are derived and beneficially owned by a resident of a Contracting State are taxable only in that State. An annuity, as the term is used in this paragraph, means a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payment in return for adequate and full consideration (other than for services rendered).

Paragraphs 3 and 4 deal with alimony and child support payments. The provisions of the two paragraphs differ, in some respects, from the comparable provisions in the U.S. Model so that they may better coordinate the provisions of U.S. and Slovak law regarding the treatment of such payments. Paragraph 3 deals only with those alimony payments that are deductible to the payor. Under the paragraph, alimony paid by a resident of a Contracting State, to the extent that it is deductible by that resident, to a resident of the other Contracting State is taxable only in the State of residence of the recipient. Paragraph 4 deals with nondeductible alimony and periodic payments for the support of a minor child. These types of payments by a resident of a Contracting State to a resident of the other Contracting State are taxable only in the State of residence of the payor.

Both alimony, under paragraph 3, and nondeductible alimony and child support payments, under paragraph 4, are defined as periodic payments made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support. In addition, for a payment to be treated as "alimony" for purposes of this Article, it must be taxable to the recipient under the laws of his State of residence.

Under U.S. law, alimony is generally deductible to the payer and taxable in the hands of the recipient. Such payments made by U.S. residents, therefore, fall within the terms of paragraph 3 and are taxable only in Slovakia. Under Slovak law, to the extent alimony is deducted by the payer, it is taxable to the recipient. In such cases, alimony paid by Slovak residents also falls under paragraph 3.

The "saving" clause of paragraph 3 of Article 1 does not apply to paragraph 4. The benefits of this paragraph, therefore, are not overridden by any contrary provisions of the Code.

Article 20. GOVERNMENT SERVICE

This Article follows the corresponding provisions of the OECD Model. The Article provides generally that payments (including a pension) from the public funds of a Contracting State or political

subdivision or local authority thereof to compensate a citizen of that State for the performance of services rendered in the discharge of functions of a governmental nature may be taxed only by that State. Payments in respect of services rendered in connection with a business carried on by that State, political subdivision or local authority (for example, a government-operated airline) are governed by the provisions of Article 14 (Independent Personal Services), 15 (Dependent Personal Services) or 18 (Artistes and Sportsmen), as the case may be, and not by Article 20.

The provisions of this Article do not apply to social security benefits and other public pensions that are not paid in respect of services rendered to the paying government or a political subdivision or local authority thereof. Such amounts are governed by the provisions of Article 19 (Pensions, Annuities, Alimony and Child Support).

The rules of this Article are an exception to the "saving" clause of paragraph 3 of Article 1 (General Scope) for individuals who are neither citizens nor permanent residents of the State where the services are performed. Thus, for example, payments by Slovakia to its employees at the Slovak Embassy in Washington are exempt from U.S. tax if the employees are not "green card" holders or citizens of both countries.

Article 21. STUDENTS, TRAINEES, TEACHERS AND RESEARCHERS

This Article deals with visiting students, trainees, and, unlike the U.S. Model, teachers and researchers.

Paragraph 1 deals with certain payments received by a student who is temporarily present in the host State for the primary purpose of study at an accredited educational institution, securing professional training, or study or research as the recipient of a grant from a governmental, religious, charitable, scientific, literary or educational organization. If such a student was a resident of the other Contracting State at the beginning of his visit, he will be exempt from tax in the host State on (i) payments (other than compensation for personal services) arising from sources, or remitted from, outside the host State, that are for the purpose of the student's or trainee's maintenance, education or training, (ii) the study or research grant, and (iii) income from personal services performed in the host State in an aggregate amount not exceeding $5,000 or its equivalent in Slovak crowns for any taxable year. These exemptions are available for a period of time not exceeding five years from the date of the student's arrival in the host State. It is expected that, in most cases, study, training or research programs would be completed within five years.

The reference in paragraph 1 to "primary purpose" is meant to describe individuals participating in a full-time program of study, training, or research. It was substituted for the reference in the OECD Model to "exclusive purpose" to prevent too narrow an interpretation. It is not the intention to exclude full-time students who, in accordance with their visas, may hold part-time employment jobs. For U.S. purposes, a religious, charitable etc. organization as described in subparagraph 1(c) is an organization that qualifies as tax-exempt under Code section 501(c)(3).

Paragraph 2 deals with a resident of a Contracting State who is an employee of an enterprise of that State and who is temporarily present in the other Contracting State for the primary purpose of studying at an accredited educational institution in the host State or acquiring technical, professional or business experience from a person other than his employer. Such resident will be exempt from tax by the host State for a period of 12 consecutive months on compensation for personal services, wherever performed, in an aggregate amount not exceeding $8,000 or its equivalent in Slovak crowns.

Paragraph 3 of the Article deals with a resident of a Contracting State who is temporarily present in the other Contracting State for a period not exceeding one year, as a participant in a program sponsored by the Government of the host State, for the primary purpose of training, research or study. Such an individual will be exempt from tax by the host State on compensation for personal services in respect of such training, research or study performed in the host State in an aggregate amount not exceeding $10,000 or its equivalent in Slovak crowns.

Paragraph 4 permits the competent authorities to agree to adjust the dollar amounts specified in paragraphs 1 through 3 to reflect significant changes in price levels over time. The exemption for income from personal services in paragraphs 1 through 3 applies only if the services are performed solely for the purposes of supplementing the funds otherwise available for the person's maintenance, education or training. The $5,000 exemption applies in addition to, and not in lieu of, any allowances (e.g., personal exemptions and deductions) available to the person under the internal laws of the Contracting States. If the amount earned exceeds $5,000 per annum, only the excess is taxable.

Paragraph 5 of the Article deals with visiting professors and teachers. Although there is no provision in the U.S. or OECD Models dealing with professors or teachers, and it is not standard U.S. treaty policy to provide benefits to visiting teachers by treaty, the United States will frequently agree to include such a provision when requested by the treaty partner. Paragraph 5 provides that if a professor or teacher who is a resident of one Contracting State visits the other Contracting State for a period not exceeding two years for the purpose of teaching or conducting

research at an accredited educational or research institution, he will be exempt from tax in the host State on his compensation for such teaching or research. A person is not entitled to the benefits of this paragraph if he has, during the immediately preceding period, enjoyed the benefits of paragraph 1, 2 or 3 of Article 21 as a student, apprentice or trainee. If, however, following the period in which a person claimed benefits under paragraph 1, 2 or 3, that person resumes residence and physical presence in his original home State before returning to the host State as a teacher or researcher, he may claim the benefits of paragraph 5. The benefits of paragraph 5 may be claimed only once by a particular individual.

Paragraph 6 clarifies that, for the exemption of paragraph 5 to apply to income from research, the research must be undertaken in the public interest, and not primarily for the private benefit of a specific person or persons. For example, the exemption would not apply to a grant from a tax-exempt research organization to search for the cure to a disease if the results of the research become the property of a for-profit company. The exemption would not be denied, however, if the tax-exempt organization licensed the results of the research to a for-profit enterprise in consideration of an arm's length royalty consistent with its tax-exempt status.

This Article is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a Slovak student, trainee, or researcher is entitled to the benefits of this Article even if such individual becomes a resident of the United States under the "substantial presence" test of Code section 7701(b). However, the benefits of this Article are not available to a U.S. citizen or "green card" holder.

Article 22. OTHER INCOME

This Article provides the rules for the taxation of items of income not dealt with in the other articles of the Convention. This Article deals with classes of income that are not dealt with elsewhere, such as lottery winnings, punitive damages, and cancellation of indebtedness income. The article also applies to items of income that are excluded from the other articles because of their source or some other characteristic. For example, Article 11 (Interest) addresses only the taxation of interest arising in a Contracting State. Interest arising in a third state therefore is subject to the rules of Article 22.

Paragraph 1 contains the general rule that such items of income derived by a resident of a Contracting State will be taxable only in the State of residence. This exclusive right of taxation applies irrespective of whether the residence State exercises its right to tax the income.

Paragraph 2 contains an exception to the general rule of paragraph 1 for income (other than income from real property) that is attributable to a permanent establishment or fixed base that is or was maintained in a Contracting State by a resident of the other Contracting State. The taxation of such income is governed by the provisions of Articles 7 (Business Profits) or 14 (Independent Personal Services). Thus, in general, third-country income that is attributable to a permanent establishment maintained in the United States by a resident of Slovakia would be taxable by the United States.

There is an exception to the rule of paragraph 2 for income from real property, as defined in paragraph 2 of Article 6 (Income from Real Property (Immovable Property)). If a Slovak resident derives income from real property located outside the United States that is attributable to the resident's permanent establishment or fixed base in the United States, only Slovakia and not the United States may tax that income. This special rule for foreign situs real property is consistent with the general rule, also reflected in Articles 6 and 23 (Capital), that only the situs and residence states may tax real property and real property income. Even if such property is part of the property of a permanent establishment or fixed base in a Contracting State, that State may not tax if neither the situs of the property nor the residence of the owner is in that State.

This Article is subject to the "saving" clause of paragraph 3 of Article 1 (General Scope). Thus the United States may tax the income of a Slovak resident not dealt with elsewhere in the Convention if that Slovak resident is a citizen of the United States.

Article 23. CAPITAL

This Article specifies the circumstances in which a Contracting State may impose tax on capital owned by a resident of the other Contracting State. Since the United States does not impose a national-level tax on capital, the only capital taxes covered by the Convention are those imposed by Slovakia. Thus, although the Article is drafted in a reciprocal manner, its provisions are relevant only for the imposition of Slovak tax.

Paragraph 1 provides that capital represented by real property (as defined in Article 6 (Income from Real Property) (Immovable Property)) that is owned by a resident of a Contracting State and situated in the other Contracting State may be taxed in the situs state. Thus, real property owned by a U.S. resident and located in Slovakia may be taxed by Slovakia.

Paragraph 2 provides the same rule for movable property that is part of the business property of a permanent establishment or

fixed base that an enterprise or resident of a Contracting State has in the other Contracting State. Thus, movable property that is part of the business property of a permanent establishment or fixed base that a U.S. enterprise or resident maintains in Slovakia may be taxed in Slovakia.

The taxing right granted to the situs State under paragraphs 1 and 2 is not an exclusive right; in both cases, the State of residence may also tax. As noted above, the United States does not impose a capital tax. The Article does not preclude Slovakia, however, from imposing its capital tax with regard to real or immovable property owned by a Slovak resident and located in the United States.

Paragraph 3 provides that capital represented by ships, aircraft or containers owned by a resident of one Contracting State and operated in international traffic may be taxed only in the residence State. This rule is consistent with the rule of Article 8 (Shipping and Air Transport) that addresses the income from international transportation activities.

Paragraph 4 provides that all other items of capital of a resident of a Contracting State shall be taxable only in the residence State.

Article 24. RELIEF FROM DOUBLE TAXATION

In this Article, each Contracting State undertakes to relieve double taxation by granting a foreign tax credit against its income tax for the income tax paid to the other country. Under paragraph 1, the credit granted by the United States is allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of this Article (the allowance of a credit) is retained. Thus, although the Convention provides for a foreign tax credit, the terms of the credit are determined by the provisions of the U.S. statutory credit, at the time the credit is given.

The U.S. foreign tax credit is generally limited under the Code to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code section 904(a)). Nothing in the Convention prevents the limitation of the U.S. credit from being applied on a per-country or overall basis or some variation thereof. In general, where source rules are provided in the Convention for purposes of determining the taxing rights of the Contracting States, these are consistent with the Code source rules for foreign tax credit and other purposes. Where, however, there is an inconsistency between Convention and Code source rules, the Code source rules (e.g., Code section 904(g)) will be used to determine the limits for the allowance of a credit under the Convention.

(Paragraph 3 of the Article provides an exception to this general rule with respect to certain U.S. source income of U.S. citizens resident in Slovakia.)

Paragraph 2 provides that Slovakia may include in the income tax base of its residents items of income that, under the Convention, are also taxable by the United States. Slovakia will credit the U.S. tax paid on such income to the extent that such tax does not exceed the amount of Slovak tax that is appropriate to the income.

Paragraph 3 provides a special rule for the tax treatment of U.S. citizens resident in Slovakia. Under this paragraph, income that may be taxed by the United States solely by reason of citizenship in accordance with the "saving" clause of paragraph 3 of Article 1 (General Scope) shall be treated as having its source in Slovakia to the extent necessary to avoid double taxation. This provision overrides U.S. law source rules only in those cases where U.S. law would operate to deny a foreign tax credit for taxes imposed by Slovakia under the provisions of the Convention on U.S. citizens resident in Slovakia. In no case, however, is this provision to reduce the taxes paid to the United States below the amount that would be paid if the individual were not a citizen of the United States, i.e., the U.S. tax imposed on a nonresident, non-citizen with respect to income arising in the United States.

As an example of the application of paragraph 3, consider a U.S. citizen resident in Slovakia who receives $200 of portfolio dividend income from United States sources and is subject to U.S. tax at 28 percent ($56) on that income. Under the provisions of Article 10 (Dividends), the United States tax on portfolio dividends paid to residents of Slovakia who are not U.S. citizens is limited to 15 percent ($30 in this case). Suppose Slovakia taxes that income of its resident at 40 percent, or $80, and grants, in accordance with the provisions of paragraph 2 of this Article, a credit for the $30 of U.S. tax imposed on the basis of source only. The net Slovak tax will be $50 and the total tax $106. Thus, the total tax is higher than either of the two countries' taxes, indicating some double taxation. The United States agrees to resource enough of that dividend income to avoid double taxation, but in no case, to reduce the U.S. tax paid below the $30 it is entitled to tax at source. In this example, the U.S. will resource enough of the dividend to permit a credit of $26, thus reducing its net tax from $56 to $30. The total tax becomes $80 ($50 + 30), the higher of the two taxes, and double taxation is eliminated. (The need for such a resourcing provision arises only if the Slovak tax exceeds the applicable U.S. tax **and** the Slovak credit permitted under its law and the treaty is limited to the U.S. tax imposed under the treaty on residents of Slovakia who are not U.S. citizens.)

By reason of paragraph 4(a) of Article 1 (General Scope), Article 24 is not subject to the provisions of the "saving" clause of paragraph 3 of Article 1. Thus, the "saving" clause cannot be used to deny a Slovak resident the benefit of the credits provided for in paragraph 1 or to deny a U.S. citizen or resident the benefit of the credits provided for in paragraphs 2 and 3.

Article 25. NON-DISCRIMINATION

This Article ensures that nationals, enterprises and residents of a Contracting State will not be subject to discriminatory taxation in the other Contracting State. For this purpose, non-discrimination means providing national treatment.

Paragraph 1 provides that a national of one Contracting State may not be subject to taxation or any connected requirement in the other Contracting State that is different from or more burdensome than the taxation and connected requirements imposed upon a national of that other State in the same circumstances. A national of a Contracting State is afforded protection under this paragraph even if the national is not a resident of either Contracting State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same treatment in Slovakia as a Slovak national who is in similar circumstances. It is understood, however, that for U.S. tax purposes, a U.S. citizen who is resident outside the United States, whether in Slovakia or a third country, is not in the same circumstances as a national of Slovakia who is a resident outside the United States, because the U.S. citizen is subject to U.S. tax on his worldwide income while the Slovak national is subject to U.S. tax only on his U.S. source income.

Paragraph 2 defines the term "nationals" to mean all individuals possessing the nationality of a Contracting State and all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State. The term includes citizens of a Contracting State.

Paragraph 3 of the Article provides that a permanent establishment in a Contracting State of a resident of the other Contracting State may not be less favorably taxed in the first-mentioned State than an enterprise of that first-mentioned State that is carrying on the same activities. This provision, however, does not oblige a Contracting State to grant to a resident of the other Contracting State any tax allowances, reliefs, etc., that it grants to its own residents on account of their civil status or family responsibilities. Thus, if an individual resident in Slovakia owns a Slovak enterprise that has a permanent establishment in the United States, in assessing income tax on the profits attributable to the permanent establishment, the United States is not obligated to allow to the Slovak resident the

personal allowances for himself and his family that he would be permitted to take if the permanent establishment were a sole proprietorship owned and operated by a U.S. resident.

Section 1446 of the Code imposes on any partnership with income effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the Convention, this obligation applies with respect to a Slovak resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraph 2 of the Article. No distinction is made between U.S. and Slovak partnerships. The requirement to withhold on the Slovak but not the U.S. partner's share is not discriminatory taxation, but, like other withholding on nonresident aliens, is a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it may otherwise be difficult for the United States to enforce its tax jurisdiction. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a refund.

Paragraph 4 of the Article specifies that no provision of the Article will prevent either Contracting State from imposing the branch tax described in paragraph 6 of Article 10 (Dividends).

Paragraph 5 prohibits discrimination in the allowance of deductions. When a resident of a Contracting State pays interest or royalties or makes other disbursements to a resident of the other Contracting State, the first-mentioned Contracting State must allow a deduction for those payments in computing the taxable profits of the enterprise under the same conditions as if the payment had been made to a resident of the first-mentioned State. An exception to this rule is provided for cases where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 6 of Article 11 (Interest) or paragraph 5 of Article 12 (Royalties) apply, because all of these provisions permit the denial of deductions in certain circumstances in respect to excessive (not at arm's length) payments between related persons. The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expense.

Paragraph 5 also provides that any debts of a resident of a Contracting State to a resident of the other Contracting State are deductible in the first-mentioned Contracting State in computing taxable capital under the same conditions as if the debt had been contracted to a resident of the first-mentioned State. At present, only Slovakia imposes a capital tax. However, this Article also

applies to taxes imposed by political subdivisions and local authorities of Slovakia and to state and local taxes in the United States. (See discussion of paragraph 7.) Thus, if such a tax is imposed on the value of real property net of debt, the same deduction must be allowed with respect to debt of creditors who are residents of either Contracting State.

Paragraph 6 requires that a Contracting State not impose other or more burdensome taxation or connected requirements on a company that is a resident of that State, and that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, than the taxation or connected requirements that it imposes on similar resident companies owned by residents of the first-mentioned State. It is understood that the rules of Code section 367(e)(2) regarding liquidating distributions of appreciated property by a U.S. subsidiary to a foreign parent corporation, the provision in Code section 1446 for withholding of tax on distributions to non-U.S. partners (discussed above), and the rule of Code section 1361 under which nonresident alien individuals are ineligible to become shareholders of subchapter S corporations, do not violate the provisions of this Article.

Paragraph 7 provides that, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered), for purposes of providing nondiscrimination protection this Article applies to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof. Customs duties are not considered to be taxes for this purpose.

The "saving" clause of paragraph 3 of Article 1 (General Scope) does not apply to this Article, by virtue of the exceptions in paragraph 4(a) of Article 1. Thus, for example, a U.S. citizen who is resident in Slovakia may claim benefits in the United States under this Article.

Article 26. MUTUAL AGREEMENT PROCEDURE

This Article provides for cooperation between the competent authorities of the Contracting States to resolve disputes that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention. The competent authorities of the two Contracting States are identified in subparagraph 1(g) of Article 3 (General Definitions).

Paragraph 1 provides that, where a person considers that the actions of one or both Contracting States result or will result for him in taxation that is not in accordance with the Convention, he may present his case to the competent authority of his State of residence or citizenship. The case must be presented within three

years from the first notification of the action resulting in taxation not in accordance with the Convention. It is not necessary for a person first to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities.

Paragraph 2 provides that, if the competent authority of the Contracting State to which the case is presented considers the case to have merit, and if it cannot reach a satisfactory solution unilaterally, it will seek agreement with the competent authority of the other Contracting State to avoid taxation not in accordance with the Convention. Any agreement reached under this provision is to be implemented even if implementation would be otherwise barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, time or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax.

Paragraph 3 authorizes the competent authorities to seek to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. It is intended that the competent authorities may agree, for example, to the same attribution of income, deductions, credits or allowances between a resident of one Contracting State and its permanent establishment in the other; to the allocation of income, deductions, credits or allowances between persons; or to settle a variety of conflicting applications of the Convention, including those regarding the characterization of items of income or of persons, the application of source rules to particular items of income, differences in meanings of a term, and differences in applying penalties, fines and interest. Agreements reached by the competent authorities under this paragraph need not conform to the internal law provisions of either Contracting State.

Paragraph 3 also authorizes the competent authorities to address double taxation in cases not provided for in the Convention, but with respect to taxes covered by the Convention. An example might be double taxation arising from a transfer pricing adjustment between two permanent establishments of a third-country resident, one in the United States and the other in Slovakia. Since no resident of a Contracting State is involved in the case, the Convention does not, by its terms, apply. The competent authorities may, nevertheless, use the authority of the Convention to seek to prevent double taxation.

Paragraph 4 authorizes the competent authorities to communicate with each other directly for these purposes. It is not necessary to communicate through diplomatic channels.

The benefits of this Article are also available to residents or citizens of either Contracting State under paragraph 4(a) of Article 1 (General Scope). Thus, rules, definitions, procedures, etc., that are agreed upon by the competent authorities under this Article may be applied by the United States with respect to its citizens and residents, even if those rules etc. differ from the comparable Code provisions. Similarly, U.S. law may be overridden to provide refunds of tax to a U.S. citizen or resident under this Article.

Article 27. EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

This Article provides for the exchange of information between the competent authorities of the Contracting States. The information to be exchanged is that necessary for carrying out the provisions of the Convention or the domestic laws of the United States or Slovakia concerning the taxes covered by the Convention. For purposes of this Article, the taxes covered by the Convention include all taxes imposed at the national level. Exchange of information with respect to domestic law is authorized insofar as the taxation under those domestic laws is not contrary to the Convention. Thus, for example, information may be exchanged with respect to any national level tax, even if the transaction to which the information relates is a purely domestic transaction in the requesting State.

Paragraph 1 states that information exchange is not restricted by Article 1 (General Scope). This means that information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For example, if a third-country resident has a permanent establishment in Slovakia that engages in transactions with a U.S. resident, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Such information would not be routinely exchanged, but may be requested in specific cases.

Paragraph 1 also provides assurances that any information received in accordance with this Article will be treated as secret, subject to the same disclosure constraints that apply to information obtained under the laws of the requesting State. Information received may be disclosed only to persons, including courts and administrative bodies, concerned with the assessment, collection, enforcement or prosecution in respect of the taxes to which the information relates, or to persons concerned with the administration of these taxes. The information must be used by such persons in connection with these designated functions. Persons concerned with the administration of taxes, in the United States, include the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies is

for use in the performance of their role in overseeing the administration of U.S. tax laws. Information received under this Article may be disclosed in public court proceedings or in judicial decisions.

Paragraph 2 explains that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures that are at variance with the laws or administrative practice of either State. Nor is either State obligated to supply information not obtainable under the laws or administrative practice of either State. Thus, there is no obligation to furnish information to the other Contracting State if either the requested State or the requesting State could not obtain such information for itself in a domestic case. There is also no obligation to disclose trade secrets or other information, the disclosure of which would be contrary to public policy. Either Contracting State may, however, at its discretion, subject to the limitations of the paragraph and its internal law, provide information that it is not obligated to provide under the provisions of this paragraph.

Paragraph 3 provides that, when information is requested by a Contracting State in accordance with this Article, the other Contracting State is obligated to obtain the requested information as if the tax in question were the tax of the requested State, even if that State has no direct tax interest in the case to which the request relates. The paragraph further provides that the requesting State may specify the form in which information is to be provided (e.g. depositions of witnesses and authenticated copies of original documents), so that the information can be used in the judicial proceedings of the requesting State. The requested State should provide the information in the form requested to the same extent that it can obtain information in that form under its own laws and administrative practices with respect to its own taxes.

Paragraph 4 provides that this Article applies to national taxes of every kind, notwithstanding the provisions of Article 2 (Taxes Covered).

Article 28. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

This Article confirms that any fiscal privileges to which members of diplomatic or consular missions are entitled under the general provisions of international law or under special agreements will apply, notwithstanding any provisions of this Convention to the contrary. This provision also applies to residents of either Contracting State, provided that they are not citizens of that State and, in the case of the United States, are not "green card" holders. (See subparagraph 4(b) of Article 1 (General Scope.)

Article 29. ENTRY INTO FORCE

This Article provides the rules for bringing the Convention into force and giving effect to its provisions. Paragraph 1 provides for the ratification of the Convention by both Contracting States and the prompt exchange of instruments of ratification.

Paragraph 2 provides that the Convention will enter into force on the date on which instruments of ratification are exchanged. Under subparagraph 2(a), the Convention will have effect with respect to taxes withheld at source for amounts paid or credited on or after the first day of the second month next following the date of entry into force. For example, if the Convention were to enter into force on December 10, 1993, the withholding rates on dividends, interest and royalties would be reduced (or eliminated) for amounts paid on or after February 1, 1994. For all other taxes, the Convention will have effect for any taxable period beginning on or after January 1 of the year in which the Convention enters into force, i.e., 1993 in the preceding example.

Article 30. TERMINATION

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of this Article. The Convention may be terminated at any time after five years from the date of its entry into force, provided that written notice has been given through diplomatic channels at least six months in advance. If such notice is given, the Convention will cease to apply in respect of taxes withheld on dividends, interest and royalties paid or credited on or after the first day of the January next following the expiration of the six-month period. The Convention will cease to apply with respect to other taxes for taxable periods beginning on or after the first day of the January next following expiration of the six-month period. Thus, for example, if notice of termination is given in July or later of a calendar year, the termination will not be effective as of the following January 1 but as of the second January 1, since the notice period must continue for at least six months.

Article 30 relates to unilateral termination by a Contracting State of the Convention. The Article does not prevent the Contracting States from entering into a new bilateral agreement that supersedes, amends or terminates provisions of the Convention, either prior to the expiration of the five-year period or without the six-month notification period.

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED MEXICAN STATES FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON ON SEPTEMBER 18, 1992

INTRODUCTION

This is a technical explanation of the Convention and Protocol between the United States and Mexico signed on September 18, 1992 ("the Convention"). The Convention is based on the U.S. Treasury Department's draft Model Income Tax Convention, published on June 16, 1981 ("the U.S. Model"), the Model Double Taxation Convention on Income and Capital, published by the OECD in 1977 ("the OECD Model"), the Model Double Taxation Convention published by the United Nations in 1980 (the "U.N. Model") and recent income tax treaty negotiations of both countries.

The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention.

The explanations of each article include explanations of any Protocol provisions relating to that article.

Article 1. GENERAL SCOPE

Paragraph 1 provides that the Convention applies to residents of the United States or Mexico, and in some cases may apply to residents of third States. Article 4 defines residents of the United States and Mexico for the purposes of the Convention. Examples of cases where the Convention may affect residents of third States include the articles on non-discrimination (Article 25) and the exchange of information (Article 27).

Paragraph 2 is the same as the corresponding provision in the U.S. Model. The Convention may not increase the tax burden of residents of either country compared to what it would be under the respective domestic law provisions or under any other agreement between the two States. Thus, for example, a right to tax given by the Convention cannot be exercised unless domestic law also provides for such a tax; and this Convention will not restrict the benefits provided by another U.S.-Mexico agreement, whether concluded previously or subsequently. This does not mean, however, that a taxpayer may pick and choose among Internal Revenue Code (hereinafter "Code") and Convention provisions in an inconsistent manner in order to minimize tax. For example, assume a resident of Mexico has three separate businesses in the United States. One is a profitable permanent establishment. The other two are trades or businesses that would earn income taxable in the United States under the Code but that do not meet the permanent establishment threshold tests of the Convention; one of these is profitable, and the other incurs a loss. Under the Convention the income of the permanent establishment is taxable, and both the profit and loss of the other two businesses are ignored. Under the Code all three would be taxable. The loss would be offset against the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B. 10.) If the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States which is not effectively connected with any of his business activities in the United States.

Paragraph 3 contains the traditional "saving" clause, which provides that each country may tax in accordance with its domestic law, without regard to the Convention, its residents, citizens, and former citizens whose loss of citizenship had tax avoidance as one of its principal purposes. Although the paragraph is drafted reciprocally, Mexico does not now tax the income on the basis of citizenship. The taxation of former citizens is limited to a period of ten years, as provided in

section 877 of the Code. "Residence", for the purpose of the saving clause, is determined under Article 4 (Residence). Thus, for example, if an individual who is not a U.S. citizen is a resident of the United States under the Code, e.g. a "green card" holder, and is also a resident of Mexico under Mexican law, and the tie-breaker rules of paragraph 2 of Article 4 determine that he is a resident of Mexico, he will be entitled to U.S. benefits under the Convention.

As a consequence of the saving clause, each article should be read as not providing benefits with respect to the U.S. taxation of U.S. citizens (wherever resident) or residents or with respect to Mexico's taxation of Mexican citizens or residents. However, paragraph 4 provides certain exceptions to the saving clause. Under subparagraph a), for example, U.S. residents and citizens are entitled to certain U.S. benefits provided under the Convention. Those benefits are: the correlative adjustments authorized by paragraph 2 of Article 9; the exemption of social security benefits paid by the other State and of child support and alimony paid by residents of the other State, that are provided in paragraphs 1 b) and 3 of Article 19; the deductibility of certain contributions to Mexican charities and the relief from expenditure responsibilities provided in Article 22; the guarantee of a foreign tax credit provided in Article 24; the nondiscrimination protection of Article 25; and the competent authority procedures of Article 26. Mexican residents are entitled to the benefits provided by Mexico under the same articles (and Mexican citizens or former citizens would be entitled to the same benefits, if relevant).

Under subparagraph b) certain additional benefits are available to US residents who are neither US citizens nor "green card" holders; these are the U.S. benefits extended to employees of the Mexican Government under Article 20, to visiting students, under Article 21, and to members of diplomatic and consular missions under Article 28. This subparagraph also applies reciprocally.

Article 2. TAXES COVERED BY THE CONVENTION

This Article identifies the taxes to which the Convention applies. Paragraphs 1 and 2 are based on the OECD model and explain that the Convention applies to taxes on income; this covers taxes on total income or any part of income and includes tax on gains derived from the alienation of property. The Convention does not apply to payroll taxes. Nor does it apply to property taxes; however, the Convention does affect the imposition of Mexico's asset tax in some instances, as explained in the Protocol.

In the case of the United States, the existing taxes to which the Convention applies are the Federal income taxes imposed

by the Internal Revenue Code, but not including the accumulated earnings tax or personal holding company tax (which are considered penalty taxes) or social security contributions. It also applies to certain excise taxes. The excise taxes with respect to private foundations are covered to the extent necessary to implement paragraph 4 of Article 22 (Exempt Organizations). The Convention also applies to the Federal excise taxes imposed on insurance premiums paid to foreign insurers, in the case of Mexican insurers, but only to the extent that the Mexican insurer does not reinsure those risks with a person not exempt from such taxes. As we have discussed in prior consultations with the staff of this Committee and of the tax-writing Committees, our review of Mexico's taxation of the income of Mexican insurance companies indicated that it results in a burden that is substantial in relation to the U.S. tax on U.S. insurance companies. It is, therefore, appropriate to waive the insurance excise tax in the case of Mexico, as in the recent Conventions ratified with Germany, Spain, Finland, India, and other countries. In addition, Article 25 (Non-Discrimination) applies to all taxes imposed at all levels of government. The exchange of information provisions of Article 27 apply to all Federal level taxes, e.g. including estate and gift and excise taxes, to the extent that such information is relevant to enforcement of the Convention or of any covered tax as long as the tax in question is applied in a manner consistent with the Convention.

In the case of Mexico, the Convention applies to the income tax imposed by the Income Tax Law, amplified in the case of Articles 25 (Non-Discrimination) and 27 (Exchange of Information) to include all taxes and all national level taxes, respectively. The assets tax is not a covered tax. However, the Protocol limits application of the assets tax in certain cases where there would be no Mexican income tax liability because of the Convention (e.g., where there is no permanent establishment), and it preserves the benefits of the Convention in cases where the tax does apply. Thus, point 3 of the Protocol generally limits application of the assets tax to cases where a U.S. resident either (i) has a permanent establishment in Mexico under Article 5, (ii) has real property in Mexico, or (iii) leases or otherwise permits a resident of Mexico to use property for which a "royalty" (as defined in Article 12) is paid. Point 6 of the Protocol also makes clear that the assets tax may not be applied to property used to produce profits that are exempt from Mexican income tax under Article 8 (Shipping and Air Transport).

Under paragraph 4, the Convention will apply to any taxes which are substantially similar to those enumerated in paragraph 3, and which are imposed in addition to, or in place of, the existing taxes after September 18, 1992, the date of signature of the Convention. Paragraph 4 also provides that the U.S. and Mexican competent authorities will notify each other of

significant changes in their taxation laws that are relevant to the operation of the Convention, and of official published materials that concern the application of the Convention.

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines a number of basic terms used in the Convention. Certain others are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Residence). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). The terms "dividends", "interest" and "royalties" are defined in Articles 10, 11 and 12, which deal with the taxation of those classes of income, respectively.

Subparagraph (a) defines the term "person" to include an individual or legal person. The latter includes a company, a corporation, a trust, a partnership, an association, an estate and any other body of persons. Any "person" may be a "resident" of a Contracting State for purposes of Article 4 and thus entitled to the benefits of the Convention. This list is somewhat more expansive than the definition in the US Model, but it is intended to have the same meaning.

The term "company" is defined in subparagraph b) as any entity treated as a body corporate for tax purposes. For U.S. tax purposes, the rules of reg § 301.7701-2 generally will be applied to determine whether an entity is a body corporate.

An "enterprise of a Contracting State" is defined, as in the U.S. and OECD Models, to mean an enterprise carried on by a resident of Mexico or the United States, as appropriate. (Although there is no explicit definition of the term "Contracting State", it refers to Mexico or the United States according to the context.)

Subparagraph d) defines the term "international traffic". The term means any transport by a ship or aircraft except when such transport is solely between places within a Contracting State. The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that the transport of goods or passengers solely between Miami and New York by a Mexican carrier (if it were permitted) would not be treated as international traffic, and the resulting income would not be exempt from U.S. tax under Article 8. It would be treated as business profits under Article 7 and would, therefore, be taxable in the United States if attributable to a U.S. permanent establishment. If, however, goods or passengers are carried by a Mexican plane from Mexico City to Miami and then to New York the trip would be international transport for those that continued to New York as well as for those that disembarked in Miami.

The "competent authority" is the Government official charged with administering the provisions of the Convention and with attempting to resolve any differences or difficulties which may arise in interpreting its provisions. The U.S. competent authority is the Secretary of the Treasury or his authorized representative. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who has, in turn, redelegated the authority to the Assistant Commissioner (International). With respect to interpretive issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International). In Mexico, the competent authority resides in the Ministry of Finance and Public Credit. In general, that function is delegated to the General Directorate of Revenue Policy and International Fiscal Affairs.

The terms "United States" and "Mexico" are defined in subparagraphs 1(f) and (g), respectively. The term "United States" means the United States as defined in the Code (section 7701 (a)(9)). Accordingly, the term does not include Puerto Rico, the U.S. Virgin Islands, Guam or any other U.S. possession or territory. It includes the fifty states, the District of Columbia, and the territorial sea. When used geographically, the "United States" also includes the continental shelf. (See point 1 of the Protocol.) It is understood that the continental shelf is covered only to the extent that any U.S. taxation therein is in accordance with international law and U.S. tax law. Currently, U.S. tax law applies on the continental shelf only with respect to the exploration for and exploitation of mineral resources under section 638 of the Code.

The term "Mexico" means Mexico as defined in the Federal Fiscal Code. When used geographically, "Mexico" includes the states thereof and the Federal District, the territorial sea and the continental shelf. As in the case of the United States, it is understood that any Mexican taxation on its continental shelf must be in accordance with international law and Mexican tax law.

The term "national" is defined in subparagraph h) to include both individuals and legal persons. This term is relevant, in particular, to Articles 20 (Government Service), 25 (Non-discrimination), and 26 (Mutual Agreement Procedure).

Paragraph 2 provides that, in the application of the Convention, any term used but not defined in the Convention will have the meaning which it has under the law of the Contracting State whose tax is being applied, unless the context requires a different interpretation.

Article 4. RESIDENCE

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. Determination of residence is important because, as noted in the explanation to Article 1 (General Scope), as a general matter only residents of the Contracting States may claim the benefits of the Convention. The treaty definition of residence is used for all purposes of the Convention, including the saving clause of paragraph 3 of Article 1 (General Scope), but it is used only for purposes of the Convention.

The determination of residence for purposes of the Convention looks first to domestic law criteria. A person subject to tax as a resident or domestic entity under the law of one of the Contracting States is a resident of that State. If that person is not a resident of the other Contracting State for tax purposes under its domestic law criteria, he or it need look no further. If such a person is a dual resident, paragraph 2 provides a series of tests for assigning a single residence to an individual. Dual resident companies are not considered to be residents of either country for treaty purposes (paragraph 3).

It is understood that the reference in paragraph 1 to persons "liable to tax" refers to those subject to the taxation laws applicable to residents, and is not meant to exclude tax-exempt organizations. Article 22 (Exempt Organizations) provides some special rules with respect to tax-exempt organizations that are residents of one of the Contracting States and entitled to the benefits of the Convention under Article 17 (Limitation on Benefits).

A person that is liable to tax in a Contracting State only in respect of income from sources within that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, a Mexican Embassy official in the United States, who may be subject to U.S. tax on U.S. source investment income but not on his non-U.S. income, would not be considered a resident of the United States for purposes of the Convention. (In most cases such an individual also would not be a U.S. resident under the Code.)

Even though a United States citizen, wherever resident, is liable to tax in the United States on worldwide income, U.S. citizenship alone does not automatically render the person a resident of the United States for purposes of the Convention. Thus, Mexico is not required to provide benefits of the Convention to a U.S. citizen resident in a third country. Point 2 of the Protocol explains that a U.S. citizen or an individual who is a U.S. resident by virtue of holding a "green" card for immigration purposes will be considered a resident of the United States for purposes of Mexican tax benefits only if the individual has a substantial presence in the United States as defined in Code section 7701(b) or if his permanent home,

personal and economic relations, or habitual abode are in the United States and not in another country. The reference to "another" country means a third country; a U.S. citizen or green card holder who is also, under paragraph 1 of this Article, a resident of Mexico, will have his residence for treaty purposes determined under paragraph 2, which includes, in subparagraph (c), citizenship as one of the tie-breakers. A U.S. citizen who is determined under paragraph 2 to be a resident of Mexico would continue to be subject to U.S. taxation under the saving clause of paragraph 3 of Article 1 (General Scope), but a green card holder determined under paragraph 2 to be a Mexican resident would not be subject to the saving clause.

Point 2 of the Protocol also explains that a partnership, estate or trust will be treated as a resident of a Contracting State only to the extent that the income derived by the partnership, estate, or trust is taxed as the income of a resident, whether in the hands of the person deriving the income or in the hands of its partners or beneficiaries. Under U.S. law, a partnership is never, and an estate or trust is often not, a taxable entity. Thus, for treaty purposes, the question of whether income received by a partnership is received by a U.S. resident will be determined by the residence of its partners (looking through any partnerships which are themselves partners) rather than by the residence of the partnership itself. In Mexico, most partnerships are taxable entities. The treatment under the Convention of income received by a trust or estate will be determined by the residence of the person subject to tax on such income, which may be the grantor, the beneficiaries, or the estate or trust itself, depending on the particular circumstances. This rule regarding the residence of partnerships, estates or trusts is applied to determine the extent to which that person is entitled to treaty benefits with respect to income which it receives from the other Contracting State.

Finally, point 2 of the Protocol clarifies that the two Contracting States and their political subdivisions are to be treated as residents of those States for purposes of treaty benefits.

If, under the laws of the two Contracting States, and thus under paragraph 1, an individual is deemed to be a resident of both Contracting States, a series of tie-breaker rules is provided in paragraph 2 to determine a single State of residence for that individual. These rules come from the OECD Model. The first test is where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State where his personal and economic relations are closer, *i.e.*, the location of his "center of vital interests". If that test is also inconclusive, or if he does not

have a permanent home available to him in either State, he will be treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither of them, he will be treated as a resident of his Contracting State of nationality. In any other case, the competent authorities are instructed to resolve his residence by mutual agreement. This could be the case, for example, where the individual is not a national of either Contracting State.

The tie-breaker rules of paragraph 2 apply only to individuals. Paragraph 3 provides that, where a person other than an individual is a dual resident under paragraph 1, such person will not be treated as a resident of either State for purposes of the Convention. Under U.S. law, a corporation that is created or organized under the laws of the United States or a state or the District of Columbia is liable to U.S. tax by reason of that incorporation and therefore is a resident of the United States under paragraph 1. A corporation that has its place of effective management in Mexico is liable to Mexican tax by reason of that activity and therefore is a resident of Mexico under paragraph 1. Thus, if a corporation organized under U.S. law had its place of effective management in Mexico, it would be a resident of both countries under their respective domestic laws. One possibility considered for resolving dual residency in such cases was to permit the competent authorities to determine a single residence in such cases. However, it was considered unlikely that either competent authority would concede to the other on this point. Thus, it was decided to exclude such persons from treaty coverage and to rely on the companies themselves not to get into the situation of dual residence.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment", which is relevant to several articles of the Convention. The existence of a current or former permanent establishment in a Contracting State is necessary under Article 7 (Business Profits) for that State to tax the business profits of a resident of the other Contracting State. Articles 10, 11 and 12 (dealing with dividends, interest, and royalties, respectively) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment or fixed base that the recipient has in the source State; if the income is or was attributable to a permanent establishment, Article 7 applies, and if the income is or was attributable to a fixed base, the principles of Article 7 apply. The term "permanent establishment" is also relevant to the application of the Mexican assets tax. As provided in point 3 of the Protocol, the assets tax in general may only be applied to the assets of, a U.S. resident if that resident has a Mexican permanent establishment.

This Article is similar in most respects to the corresponding Articles of the U.S. and OECD Models, but includes some departures from those Models.

Paragraph 1 provides the basic definition of the term "permanent establishment". As used in the Convention, the term means a fixed place of business through which a resident of one Contracting State carries on business activities in the other Contracting State.

Paragraph 2 contains a list of examples of fixed places of business that constitute a permanent establishment: a place of management, a branch, an office, a factory, a workshop, and a mine, well, quarry or other place of extraction of natural resources. The use of singular nouns in this illustrative list is not meant to imply that each such place necessarily represents a separate permanent establishment. In the case of mines or wells, for example, several such places of business could constitute a single permanent establishment if the project is a whole commercially and geographically. (See the following discussion under construction sites and drilling operations.)

Paragraph 3 adds that a building or construction site or installation project, or an installation or drilling rig or ship used to explore for or exploit natural resources also constitutes a permanent establishment, but only if it lasts more than 6 months. This is a shorter period than the 12 months provided for in the U.S. and OECD Models. This paragraph follows instead the UN Model. The 6 month test has been accepted in some other U.S. tax treaties, e.g. with Spain and Tunisia, and has been reduced further in the treaties with Indonesia and India.

The furnishing of supervisory activities at such a site or installation may also constitute a permanent establishment and is taken into account in measuring the 6 month period. The addition of the reference to supervisory services is not considered a substantive difference from the U.S. or OECD Models. The commentary to paragraph 3 of Article 5 of the OECD Model, which constitutes the generally accepted international interpretation of the language in that paragraph, points out that activities of planning and supervision are taken into account, as is time spent by subcontractors at the site or project, in determining whether the general contractor has a permanent establishment. Supervisory services that do not themselves last for more than 6 months may nonetheless be an interrelated part of a construction, installation, building, or drilling project; in that case, the period of time during which supervisory services were carried on will be added to the time during which the construction, installation, building, or drilling is carried on for purposes of meeting the 6 month test.

The 6 month period applies separately to each site or project. The period begins when work (including preparatory work carried on by the resident) physically begins in a Contracting State. A site should not be regarded as ceasing to exist when work is temporarily discontinued. A series of contracts or projects which are interdependent both commercially and geographically are to be treated as a single project. For example, the construction of a housing development would be considered a single project even though each house may be constructed for a different purchaser. If the 6 month threshold is exceeded, the site or project constitutes a permanent establishment from the first day. Drilling rigs, both onshore and offshore, are covered by the construction site rule, and must, therefore, be present in a Contracting State for 6 months to constitute a permanent establishment. The drilling of several wells within the same geographic area and as part of the same commercial operation will be considered a single permanent establishment.

Paragraph 4 contains exceptions to the general rule of paragraph 1. The paragraph lists a number of activities which may be carried on through a fixed place of business, but that, nevertheless, will not give rise to a permanent establishment. Using facilities or maintaining a supply of goods or merchandise solely to store, display, or deliver goods or merchandise belonging to an enterprise will not constitute a permanent establishment of that enterprise. Similarly, maintaining a supply of goods or merchandise solely for the purpose of processing by another enterprise will not give rise to a permanent establishment of the enterprise owning the goods or merchandise. (See, however, the discussion below about paragraph 5 and its treatment of certain dependent agents that process goods on behalf of an enterprise using assets furnished by the enterprise.) The maintenance of a fixed place of business solely for purchasing goods or collecting information for the enterprise, or for carrying out any other activity of a preparatory or auxiliary character for the enterprise, such as advertising, supplying information, conducting scientific research, or placing loans will not constitute a permanent establishment of the enterprise. A combination of such activities will not constitute a permanent establishment, provided that the aggregate activity is of a preparatory or auxiliary character for the enterprise.

The exclusion of an office used for preparations relating to the placement of loans is not in the U.S. or OECD Models. It refers to representative offices in Mexico of U.S. banks, which generally are not allowed under current Mexican banking law to accept deposits or otherwise conduct a banking business in Mexico. In such cases, loans from the U.S. home office to Mexican borrowers will not be attributable to a permanent establishment in Mexico, and the interest paid will be subject to

Mexican tax in accordance with Article 11 (Interest). It is expected that U.S. banks may be able to establish branches in Mexico that will be permanent establishments taxable in accordance with Article 7 (Business Profits).

Paragraphs 5, 6 and 7 specify when the use of an agent will constitute a permanent establishment. Under subparagraph (a) of paragraph 5, a dependent agent of an enterprise will be deemed to be a permanent establishment of the enterprise if the agent has and habitually exercises an authority to conclude contracts in the name of that enterprise. If, however, the agent's activities are limited to those activities specified in paragraph 4 which would not constitute a permanent establishment if carried on directly by the enterprise through a fixed place of business, the agent will not be a permanent establishment of the enterprise. Under subparagraph (b) of paragraph 5, a dependent agent who does not have the authority to conclude contracts in the name of the enterprise will nevertheless be a permanent establishment of the enterprise if the agent habitually processes on behalf of the enterprise goods or merchandise owned by the enterprise using assets furnished, directly or indirectly, by the enterprise or an associated enterprise. This subparagraph is meant to clarify that a dependent agent that processes inventory of its principal using assets of the principal (or a related enterprise) without itself having ownership of either the inventory or the assets used in the processing, represents a permanent establishment of the principal. This is the case whether or not the dependent agent is a subsidiary of the U.S. enterprise. Because such an agent represents a permanent establishment, the income and assets attributable to its activity are subject to income and assets tax in Mexico. As mentioned above, this subparagraph is intended simply as a clarification. It is not meant to create a permanent establishment where one would not exist without this language. It does not apply to the use of an independent agent, such as a contract manufacturer. In such a case the contract manufacturer would be subject to tax by Mexico, but the person on whose behalf the processing is undertaken would not have a permanent establishment, and pursuant to point 3 of the Protocol, Mexico's assets tax would not apply to the assets of such person.

Paragraph 6 inserts a special rule for insurance companies, similar to the rule found in the U.S. treaties with Belgium and France. Mexico does not have a tax comparable to the U.S. insurance excise tax. Although foreign insurers are not now permitted to operate in Mexico, Mexico anticipates a greater opening of its financial sector in this regard. The Mexican delegation wished to clarify the rules that will apply when U.S. insurers are permitted to insure risks in Mexico by specifying in the Convention that a dependent agent who collects premiums or insures risks in Mexico on behalf of a U.S. insurer is a permanent establishment of the U.S. insurer in Mexico. There is an exception for reinsurance. This rule applies reciprocally.

Thus, although the United States (by covering it in Article 2 (Taxes Covered)) agrees not to apply the insurance excise tax to Mexican companies that do not reinsure with persons subject to those taxes, if the Mexican company maintains a dependent agent in the United States who collects premiums or insures risks on its behalf, the United States may impose its net income tax. Consistently with the rule of paragraph 2 of Article 1 (General Scope) that prevents the imposition of tax by the Convention, the tax so imposed could not exceed the tax that would apply under U.S. law.

Under paragraph 7, an enterprise will not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as such and if their relationship is at arm's length; both conditions must be satisfied.

Paragraph 8 clarifies that a company that is a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it controls, or is controlled by, a company that is a resident of that other Contracting State, or that carries on business in that other Contracting State. The determination of whether or not a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether or not a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

Article 6. INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY)

Paragraph 1 provides the standard income tax treaty rule that income derived from real property (here referred to as immovable property, as in the OECD Model and Mexican usage) may be taxed in the Contracting State where the property is located. This includes income from agriculture or forestry. Since paragraph 5 of this Article permits net basis taxation, it should have the same result in principle as Article 7 (Business Profits) in the case of an agricultural or forestry enterprise that makes the election to be taxed on a net basis.

Paragraph 2 defines real property in accordance with the laws of the Contracting States, but provides that it includes, in any case, immovable property as described in the OECD Model, which includes references to accessory property, livestock and equipment used in agriculture and forestry, and rights to receive payments in exchange for the right to extract natural resources. Boats, ships, aircraft and containers are not immovable property.

Paragraph 3 clarifies that the Article covers income from the use of real property, without regard to the form of exploitation, and paragraph 4 clarifies that it also covers immovable property used in a business or for performing independent personal services.

Paragraph 5 provides that the taxpayer (whether an individual or a legal entity) may make a binding election to be taxed on a net basis. The election is based on the 1981 U.S. model provision. However, it does not require the consent of both competent authorities to terminate the election; only the agreement of the competent authority of the State in which the property is located is required. Under Mexican law, income from the leasing of real property is taxed on a net basis when derived by resident corporations. Resident individuals may elect to be taxed on a presumed net income equal to 50 percent of the gross income. Nonresidents are taxed at 21 percent of the gross amount. When the Mexican corporate tax rate was 42 percent, this represented a 50 percent presumed expense allowance. At a rate of 35 percent, it amounts to a 40 percent deduction for expenses. And if the Mexican rate is reduced to 34 percent, as has been proposed, the 21 percent tax on gross income will reflect presumed expenses of 38 percent.) This paragraph will permit U.S. residents to be taxed on a net basis, like Mexican corporations. If they so elect, they must be able to document expenses, and must forego the presumed expense deduction.

Point 3 of the Protocol provides that, in applying its asset tax to immovable property, Mexico shall allow a credit for the gross income tax which would have applied under its statutory rules (21 percent at the time the treaty was signed), even if the U.S. owner elects to pay tax on the net income. This credit is available only if less than 50 percent of the U.S. owner's gross income from the property is used, directly or indirectly, to meet liabilities to persons who are not United States residents; otherwise Mexican (or third country) owners of Mexican immovable property could avoid the asset tax by making the U.S. resident the nominal owner of the property, while retaining beneficial ownership in Mexico (or in the third country).

Article 7. BUSINESS PROFITS

This Article provides the rules for the taxation by a Contracting State of the business profits of a resident of the other Contracting State. The general rule is found in paragraph 1, that business profits of a resident of one Contracting State may not be taxed by the other Contracting State unless the resident carries on or has carried on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated in the latter State. Where that condition is met, the State in which the permanent establishment is situated may tax the business profits

attributable to the assets or activity of that permanent establishment. That State may also tax the business profits derived from the sales of goods or merchandise of the same or similar kind as those sold through the permanent establishment. The latter rule, which comes from the U.N. Model, amounts to a partial "force of attraction", by attributing to the permanent establishment home office sales of the same or similar goods as those sold through the permanent establishment, even if, under paragraph 5 of this Article, the assets and activities of the permanent establishment were not involved in the sale. This limited "force of attraction" rule is frequently requested by developing countries to prevent avoidance of their tax at source. It has been agreed to in some other U.S. income tax treaties, such as those with India and Indonesia, although it is not in the U.S. Model and does not represent the preferred U.S. policy. In this Convention it is subject to the significant qualification that the limited force of attraction will not apply if the enterprise demonstrates that the sales were not made from the home office to avoid the tax on profits attributable to a permanent establishment. For example, it may be more efficient for a U.S. company based in San Diego and having a permanent establishment in Mexico City to sell goods to Tijuana directly from San Diego, whereas that may not be the case with respect to sales to Mexico City.

Paragraph 2 provides that the Contracting States will attribute to a permanent establishment the profits that it would be expected to make if it were an independent entity, engaged in the same or similar activities under the same or similar conditions. Profits so attributable to a permanent establishment are taxable in the State where the permanent establishment is situated or was situated at the time the profits were made. This rule incorporates the rule of section 864 (c)(6) of the Internal Revenue Code with respect to deferred payments. If the income was attributable to the assets or activities of a permanent establishment when earned, it is taxable by the State where the permanent establishment was located, even if receipt of the income is deferred until the permanent establishment has ceased to exist.

The profits attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, certain items of foreign source income described in section 864(c)(4)(B) or (C) of the Code may be attributed to a U.S. permanent establishment of a Mexican resident and subject to tax in the United States. The concept of "attributable to" in the Convention is narrower than the concept of "effectively connected" in section 864(c) of the Code. The limited "force of attraction" rule in Code section 864(c)(3), therefore, is not applicable under the Convention to the extent that it is broader than the rule of subparagraph (b) of paragraph 1 of this Article.

Paragraph 3 provides that the tax base must be reduced by deductions for expenses incurred for the purposes of the permanent establishment. These include expenses directly incurred by the permanent establishment and a reasonable allocation of expenses incurred by the home office, as long as the expenses were incurred on behalf of the company as a whole, or a part of it which includes the permanent establishment. Allocable expenses would include executive and general administrative expenses, research and development expenses, interest, and charges for management, consultancy, or technical assistance, wherever incurred and without regard to whether they are actually reimbursed by the permanent establishment. However, as clarified in point 5 of the Protocol, no double deduction is allowed, i.e. expenses included in the cost of goods sold or reflected in other charges deductible by the permanent establishment may not be included in the amount of expenses to be allocated in part to the permanent establishment.

Paragraph 3 also clarifies, as does the UN Model and the commentary to the OECD Model, that a permanent establishment may not take deductions for royalties, fees, commissions, or service fees paid to its home office other than amounts which represent reimbursement of actual expenses incurred by the home office. Since the permanent establishment and home office are parts of a single entity, there should be no profit element in such intra-company transfers. The same rule applies to interest on an intra-company loan, with the exception that a Contracting State may permit a branch bank to deduct an interest payment to its home office or another branch in excess of reimbursement of costs incurred. The exception in the case of banks is included in the UN Model and in the OECD commentary to take into account that it is common practice for parts of the same international financial institution to make advances to each other and charge interest on those amounts. It is included in this Convention to address a problem under Mexican law.

Mexico does not currently have in place a mechanism analogous to United States Treasury Regulation § 1.882-5 for allocating an enterprise's interest expense to a permanent establishment. Mexico generally permits a branch to deduct interest only when it borrows money directly. The treaty confirms that in the event Mexico in the future permits a U.S. bank to establish a branch in Mexico, that branch will be able to deduct interest initially incurred by the home office or another branch. Paragraph 3 enables Mexico to consider actual transactions between the home office and its branch to determine the appropriate interest expense deductible by the branch.

The exception in paragraph 3 for bank interest was not intended to override § 1.882-5 in the context of a U.S. permanent establishment of a Mexican bank. Paragraph 3 does not prescribe or preclude any particular method for allocating interest expense

to a branch. Thus, Mexico may consider actual intra-branch transactions, and the U.S. may approximate the appropriate interest expense of the branch under section 882. The exception for bank interest is written in a way that permits but does not require a deduction for an intra-company transaction. The general rule in the second sentence of paragraph 3 is that a Contracting State may not permit deductions for certain intra-company payments. Intra-company bank interest is an exception to this mandatory disallowance of deductions. Thus, a Contracting State may but is not required to grant a deduction for interest paid on actual intra-company transactions. If the actual amount of interest payable with respect to liabilities on the books of a U.S. branch of a Mexican bank (including amounts due to other offices) exceed the amount of interest allocated to the branch under Treas. Reg. § 1.882-5, the regulatory formula will prevail, and any such excess will not be considered incurred for the purposes of the branch under this Article (and will not be subject to a branch level interest tax under section 884).

Point 4 of the Protocol provides that nothing in Article 7 prevents a Contracting State from applying its internal law to estimate the profits of a permanent establishment where the information available is inadequate to determine those profits, or prevent Mexico from applying Article 23 of its Income Tax Law, that apportions the worldwide net income of international transportation companies on the basis of the ratio of Mexican to worldwide gross receipts. In any case in which internal law is thus applied, the determination of the profits of the permanent establishment must be consistent, on the basis of the available information, with the principles of Article 7. Article 23 of Mexico's Income Tax Law, by recognizing that there may be cases where there is no taxable income, satisfies this condition.

Paragraph 4 provides that no business profits will be attributed to a permanent establishment because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent establishment that performs at least one function for the enterprise in addition to purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's manufacturing operation and sell the manufactured output. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable with respect to its purchasing activities. If the sole activity were the purchasing of goods or merchandise for the enterprise, the issue of the attribution of income would not arise, because, under subparagraph 4(d) of Article 5 (Permanent Establishment), there would be no permanent establishment.

Paragraph 5 provides that the business profits to be "attributed" to a permanent establishment include only the profits (or losses) derived from the assets or activities of the

permanent establishment. Thus, for example, a U.S. company may have a construction site in Mexico that constitutes a permanent establishment and may also export merchandise directly from the U.S. home office to independent distributors in Mexico; it would not attribute any of the profit from the merchandise sales to the Mexican permanent establishment if the assets and personnel of that permanent establishment were not involved in the sales activity. Note, however, that paragraph 1 (b) provides an exception to this rule. Where it is applicable, paragraph 1(b) takes precedence over paragraph 5.

To ensure continuous and consistent tax treatment, paragraph 5 also requires that the method for calculating the profits and losses of a permanent establishment be the same from year to year unless there is a good and sufficient reason to change the method. A taxpayer may not vary the method from year to year simply because a different method achieves a more favorable tax result.

Paragraph 6 explains the relationship between the provisions of Article 7 and other provisions of the Convention. Under paragraph 6, where business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those other articles will, except where they specifically provide to the contrary, take precedence over the provisions of Article 7. Thus, for example, the taxation of interest will be determined by the rules of Article 11 (Interest), and not by Article 7, except where, as provided in paragraph 3 of Article 11, the interest is attributable to a permanent establishment, in which case the provisions of Article 7 apply.

Article 8. SHIPPING AND AIR TRANSPORT

This Article provides the rules that govern the taxation of income from the operation of ships and aircraft in international traffic. "International traffic" is defined in subparagraph 1(d) of Article 3 (General Definitions). Such income, when derived by a resident of either Contracting State, may be taxed only by that State, the country of residence. If the other Contracting State is the country where the income arises, it must exempt the income from tax, even if attributable to a permanent establishment in that State.

Income from the rental of ships or planes on a full basis for use in international traffic is considered operating income and is covered under paragraph 1. Income from the bareboat leasing of ships or planes is also exempt from tax at source if the ships or aircraft are used in international traffic by the lessee and if the rental income to the lessor is accessory to income derived by the lessor from operating ships or planes in

international traffic. The profits referred to in paragraph 1 do not, however, include accessory profits derived from the furnishing of overnight accommodations by an international shipping or airline enterprise. Nor does paragraph 1 apply to profits derived by such an enterprise from furnishing other means of transport, such as inland transport by truck or rail, that the international operating company provides directly. If inland transport from the port of entry to the final destination is subcontracted by the international carrier to a domestic enterprise, no profit will be attributed to the international carrier for that portion of the transport. (The domestic carrier will, of course, be subject to tax on its profit.) Mexico was not prepared to permit a U.S. company to provide such inland transport without incurring tax in the same manner as a domestic company. Similarly, Mexico was not willing to extend the exemption provided by this Article to include income from international transport by truck or rail, as is done in the U.S. treaty with Canada.

Paragraph 3 provides that income from the use of containers in international traffic and from the use of related equipment for the transport of such containers is exempt from tax at source under this Article, whether derived by an operating company or by a leasing company. The use of containers and related equipment includes charges for the rental of the equipment and charges for its delayed return.

Paragraph 4 clarifies that the exemptions provided by paragraphs 1 and 3 apply to profits from participation in a pool, joint business, or international transportation operating agency. For example, if a Mexican airline were to form a consortium with other national airlines, the share of the income derived from U.S. sources accruing to the Mexican participant would be covered by this Article.

Point 6 of the Protocol provides that the Mexican assets tax will not apply to assets used by residents of the United States to produce profits that are exempt from Mexican income tax under this Article.

When this Article takes effect, the provisions of the exchange of notes of August 7, 1989 concerning reciprocal exemption of international shipping and airline income will cease to apply. It was the request of Mexico that the Convention replace the 1989 note rather than having both documents apply simultaneously.

Article 9. ASSOCIATED ENTERPRISES

This Article provides that, when residents of the two Contracting States that are related persons engage in transactions that are not at arm's length, the Contracting States

may make appropriate adjustments to the taxable income and tax liability of such persons to reflect the income or tax with respect to such transactions that each would have had if the transaction between them had been at arm's length.

Paragraph 1 deals with the circumstance where an enterprise of a Contracting State is associated with an enterprise of the other Contracting State and those associated enterprises make arrangements or impose conditions in their commercial or financial relations that differ from those that would be made at arm's length. Paragraph 1 provides that, under those circumstances, either Contracting State may adjust the income (or loss) of the enterprise that is a resident of that State to reflect the income that would have been taken into account in the absence of such a relationship. The paragraph specifies what the term "associated enterprises" means in this context. An enterprise of one Contracting State is associated with an enterprise of the other Contracting State if either participates directly or indirectly in the management, control, or capital of the other. The two enterprises are also associated if there is a "brother-sister" type connection between them in that a third person or persons participate directly or indirectly in the management, control, or capital of both. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable.

Paragraph 2 provides that, where a Contracting State has made an adjustment that is consistent with the provisions of paragraph 1, and the other Contracting State agrees that the amount of the adjustment is appropriate to reflect arm's-length conditions, that other State is obligated to make a corresponding adjustment to the tax liability of the related person in that other State in accordance with the provisions of paragraph 2 of Article 26 (Mutual Agreement Procedure). That paragraph imposes certain time limits within which the competent authority must be notified of the case and within which agreement on the adjustment must be reached. The Contracting State making the correlative adjustment will take into account the other provisions of the Convention, where relevant.

The saving clause of paragraph 3 of Article 1 (General Scope) does not apply to this paragraph. (See Article 1 (4)(a).) Thus, even if the statute of limitations has run, or there is a closing agreement between the Internal Revenue Service and the taxpayer, a refund of tax may be required to implement a correlative adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because, under paragraph 2 of Article 1 (General Scope), the Convention cannot restrict any statutory benefit.

Point 7 of the Protocol provides that the benefits of the correlative adjustment required by paragraph 2 shall not apply if

the misstatement of profits which gave rise to the initial adjustment was the result of fraud, gross negligence, or willful default.

Paragraph 3 preserves the rights of the Contracting States to apply internal law provisions relating to adjustments between related parties. Such adjustments -- the distribution, apportionment, or allocation of income, deductions, credits or allowances -- are permitted even if they are different from, or go beyond, those authorized by paragraph 1 of the Article, so long as they accord with the general principles of paragraph 1, i.e., that the adjustment reflects what would have transpired had the related parties been acting at arm's length.

Article 10. DIVIDENDS

This Article provides rules limiting the taxation at source of dividends paid by a company that is a resident of one Contracting State to a shareholder who is a resident of the other Contracting State.

Paragraph 1 preserves the residence country's general right to tax its residents on dividends paid by a company that is a resident of the other Contracting State. The same result is achieved by the saving clause of paragraph 3 of Article 1.

Paragraphs 2 and 3 limit the right of the source State to tax dividends paid to a resident of the other State. The tax at source must not exceed 5 percent of the gross amount of a "direct investment" dividend--that is a dividend to a beneficial owner that is a company owning at least 10 percent of the voting stock of the paying corporation; in other cases it must not exceed 15 percent. After the provisions of this Article have been in effect for five years (see Article 29 (Entry Into Force)), the 15 percent rate will decrease to 10 percent. The limitation of the tax at source to 10 percent on portfolio dividends is not part of the U.S. Model, which sets a 15 percent maximum rate on such dividends. It was accepted in this case as part of a package of concessions involving the withholding rates applicable to dividends, interest, and royalties and the treatment of the Mexican assets tax. Under current Mexican law, there is no shareholder level tax on dividends.

Point 8(b) of the Protocol further provides that, if the United States should agree in a treaty with any other country to reduce its tax on direct investment dividends to a rate lower than 5 percent, that rate shall also apply to direct investment dividends paid to residents of Mexico and the United States under paragraph 2(a) of this Article, in place of the 5 percent rate provided for in that subparagraph. Such reduction is expected to take effect at the same time as it takes effect in the U.S. treaty with the third country. In reviewing the treaty with the

third country, the U.S. Senate would have the opportunity to consider the effects of the lowered rate with Mexico and take that effect into account in offering its consent to ratification.

Point 8(a) of the Protocol modifies the limitations on source country taxation for dividends paid by U.S. Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs). Dividends paid by RICs are subjected to the 15 (or, after five years, 10) percent portfolio dividend rate regardless of the percentage of voting shares of the RIC held by the owner of the dividend. The 5 percent rate, is intended to relieve multiple levels of corporate taxation. Since RICs do not pay corporate tax with respect to amounts distributed, the only tax imposed on their distributions is the shareholder level tax. Moreover, a foreign shareholder could own a 10 percent interest in a RIC without owning a 10 percent interest in the companies in which the RIC invests. In the case of dividends paid by a REIT, the 15 (after five years, 10) percent rate will apply if the beneficial owner of the dividends is an individual and holds less than 10 percent interest in the REIT. In other cases the rate of domestic law applies to dividends paid by REITS; that rate is currently 30 percent, which approximates the applicable tax if the shareholder had invested directly in U.S. real estate.

The rate limitations provided by paragraphs 2 and 3 do not affect the taxation by either Contracting State of the profits out of which the dividends are paid. (The current rates of profits tax are generally 35 percent in both the United States and Mexico, although there is a proposal in Mexico to reduce its rate to 34 percent.) Under Mexican law there is no shareholder level tax on profits distributed as dividends, provided that the full corporate level tax has been paid. Where the corporate tax has been reduced by tax preferences, a compensatory tax is imposed on the corporation at the time of distribution to recapture those preferences. Imposition of this tax is not affected by the limitations of paragraphs 2 and 3.

Paragraph 4 defines the term "dividends" as used in this Article. It is a broad definition, encompassing income from any shares or rights that are not debt claims and that participate in profits, and income from other corporate rights treated for domestic law tax purposes as dividends in the country of residence of the distributing company. Point 9 of the Protocol provides that each Contracting State may also apply its statutory rules for distinguishing debt and equity or for preventing thin capitalization in defining dividends for purposes of this Article. In the case of the United States, these rules include Code section 163(f) as modified by section 13228 of the Omnibus Budget Reconciliation Act of 1993.

Paragraph 5 provides that, where dividends are attributable to a permanent establishment or fixed base that the beneficial

owner maintains or maintained in the past in the country of source, they are not subject to the provisions of paragraphs 1, 2 and 3 of this Article, but are taxable under Article 7 (Business Profits) or Article 14 (Independent Personal Services), as appropriate.

Paragraph 6 provides that neither Contracting State may impose a tax on dividends paid by residents of the other State, or of a third State, except to the extent paid to a resident of the first State or attributable to a permanent establishment or fixed base in that first State. This paragraph precludes the U.S. from imposing its so-called "second-level withholding" tax, which generally accomplishes the same objective as the branch tax (which the treaty preserves). Paragraph 6 is drafted in such a way as to exempt not only Mexican corporations but also third-country corporations with U.S. permanent establishments from second-level withholding. Such third-country corporations may not be subject to the branch tax. However, those corporations will only be exempt from second-level withholding under this treaty to the extent their dividends are paid to Mexican shareholders who are entitled to treaty benefits. In any event, third-country corporations would be used to "shop" this treaty only in rare circumstances where the third-country company is itself exempt from the branch tax and where the rate of withholding on dividends paid from the corporation to Mexican shareholders is less than the 5 percent branch tax permitted by the treaty.

Article 11. INTEREST

This Article limits the taxation at source of interest paid by a resident of one Contracting State to a resident of the other Contracting State.

Paragraph 1 preserves the residence country's general right to tax its residents on interest arising in the other State. The same result is achieved by the saving clause of paragraph 3 of Article 1 (General Scope).

Paragraphs 2, 3, and 4 limit the right of the source State to tax interest beneficially owned by a resident of the other State. However, the reduced rates do not apply to interest paid with respect to back-to-back loans. Such interest will continue to be taxed in accordance with the domestic law of the source State.

Paragraph 3 specifies the rates that may be imposed at source during the first five years from the date on which this Article takes effect (see Article 29 (Entry Into Force)). During that period, interest on loans from banks and insurance companies, and interest on bonds or other securities that are regularly and substantially traded on a recognized securities

market may be taxed at 10 percent of the gross amount of interest paid. (A recognized securities market for this purpose is defined in point 15 b) of the Protocol.) This rate applies to a bank or insurance company that is the beneficial owner of the interest, whether or not the bank or insurance company was the original creditor on the loan; it does not apply to interest beneficially owned by another person even if the loan was originally granted by a bank or insurance company.

During the first five years other interest, except that exempt from tax at source under paragraph 4, is subject to a maximum tax at source of 15 percent of the gross interest.

At the end of five years, the rates specified in paragraph 2 will apply. The 10 percent rate applicable to interest on loans by banks and insurance companies (except back-to-back loans) and interest on publicly traded securities will drop to 4.9 percent. The effect of the 4.9 percent is to ensure that the interest is not "high withholding tax interest" for purposes of the U.S. foreign tax credit limitation but rather financial services income or passive income, as applicable. The 15 percent rate will drop to 10 percent for interest paid by banks and interest paid to a seller to finance the purchase of machinery and equipment, but will remain at 15 percent for all other categories of interest. In the case of suppliers' credits, the 10 percent rate only applies to the original seller of the goods. If the loan is transferred, the rate will be either 4.9 percent, if the loan is acquired by a bank or insurance company, or 15 percent, if acquired by another person. (See point 10 b) of the Protocol.)

Paragraph 4 specifies certain categories of interest that, notwithstanding the provisions of paragraphs 2 and 3, are exempt from tax at source when the beneficial owner is a resident of the other Contracting State. Those categories are: (i) interest paid to or by either Contracting State or a political subdivision or local authority thereof, (ii) interest beneficially owned by a tax exempt pension plan, provided that such pension plan is generally exempt from income taxation in its residence State and more than half of its beneficiaries are entitled to benefits of the Convention (see paragraph 1 e) of Article 17 (Limitation on Benefits)), and (iii) interest on loans of three years or longer that are made, guaranteed, or insured by a specified public lending institution. The specified Mexican institutions are the Banco Nacional de Comercio Exterior, S.N.C., and the Nacional Financiera, S.N.C. The specified U.S. institutions are the Export-Import Bank and the Overseas Private Investment Corporation.

In the absence of the Convention, Mexico's withholding rates on interest paid to nonresidents are currently 35 percent, 21 percent, and 15 percent, depending upon the type of debt involved

and on the identity of its holder. Mexico also exempts certain interest from income taxation. In general the treaty exemptions correspond to the statutory exemptions of Mexican law, and the categories of debt to which the reduced rates apply reflect the Mexican statutory categories. The general U.S. statutory rate is 30 percent, with an exemption for portfolio interest.

The reduced rates of paragraphs 2, 3 and 4 do not apply to an excess inclusion with respect to a residual interest in a U.S. Real Estate Mortgage Investment Conduit ("REMIC"), which will be taxed at the rate provided by U.S. domestic law. Point 10 a) of the Protocol is drafted to also permit Mexico to apply its domestic law if it in future develops a product identical to a REMIC. Further, the Protocol provides for consultations by the competent authorities as to the desirability of extending this rule to a substantially similar entity or instrument developed in future by either or both Contracting States.

Paragraph 5 defines the term "interest", as used in the Convention, to include income from debt claims of every kind, as well as income treated as income from money lent by the taxation law of the source State. In particular, income from government securities, income from bonds or debentures, and any premiums or prizes attaching to such securities, bonds or debentures are considered interest. Interest on bank deposits and on loans secured by mortgages is also covered. Point 9 of the Protocol clarifies that this definition does not override any domestic law distinction between debt and equity. The definition does not refer to penalties and fines for late payment. Thus, such amounts will be imposed in accordance with domestic law and may be taxed in at source under Article 23 (Other Income).

Paragraph 6 provides an exception from the rules of paragraphs 1, 2, and 3 in cases where the beneficial owner of the interest, who is a resident of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base situated in that other State and the interest arises in that other State and is attributable to that permanent establishment or fixed base. In such a case, the income is taxable to the permanent establishment or fixed base in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services). This rule applies even if the permanent establishment or fixed base no longer exists when the interest is received, as long as the interest was attributable to the permanent establishment or fixed base when earned.

This paragraph does not affect the exemptions provided in paragraph 4. The interest described in paragraph 4 is exempt from tax at source even if attributable to a permanent

establishment or fixed base that the beneficial owner has in the State where the interest arises.

Paragraph 7 provides a source rule. Interest is considered to arise in a Contracting State if paid by a resident of that State (including the State itself). As an exception, interest paid by any person which is borne by a permanent establishment or fixed base in one of the Contracting States is considered to arise in that State. For this purpose, interest is considered to be borne by a permanent establishment or fixed base if it is allocable to taxable income of that permanent establishment or fixed base. If the actual amount of interest on the books of a U.S. branch of a Mexican company exceeds the amount of interest allocated to the branch under Treas. Reg. § 1.882-5, any such interest will not be considered U.S. source interest for purposes of this Article.

Paragraph 8 provides that if, as a result of a special relationship between persons, the interest paid is excessive, Article 11 applies only to the amount of interest payments that would have been made absent such special relationship (i.e., an arm's length interest payment). Any excess amount of interest paid remains taxable according to the laws of the source State, with due regard to the other provisions of the Convention. Thus, for example, if the excess amount would be treated as a distribution of profits, such amount could be taxed as a dividend rather than as interest, but the tax would be subject to the rate limitations of paragraphs 2 and 3 of Article 10 (Dividends).

ARTICLE 11A. BRANCH TAX

Article 11A permits the U.S. to impose its branch taxes on the dividend equivalent amount and the excess interest of a Mexican company which derives business profits attributable to a U.S. permanent establishment or which derives income subject to tax on a net basis in the U.S. under Articles 6 (Income from Immovable Property) or 13 (Capital Gains). These branch taxes are imposed under Code section 884. The tax on the dividend equivalent amount is limited to 5%, the same rate that applies to direct investment dividends.

Excess interest is generally the portion of the entire enterprise's interest expense that is allocated to the branch over the amount of interest paid by the branch to third parties. The excess amount is deemed to be paid to the head office, and a tax is applied to the amount of that deemed payment. Excess interest is treated as U.S. source under Article 11 because it is borne by the permanent establishment. The rate of tax is limited to 10 percent, the rate generally applicable to interest payments to residents of the other Contracting State. After five years, the rate drops to 4.9 percent if the excess interest is deemed

paid to a bank or insurance company branch, the same rate that will then apply to interest on loans made by banks or insurance companies. The formula for calculating excess interest in paragraph 2 b) does not require that interest be fully deductible in one year. Rather, interest may be "excess interest," even though not "deductible" in a particular year, if it is "allocable" to the U.S. income under U.S. domestic law rules.

Just as, under Mexico's current system, there is no shareholder level tax on dividends, there also is no comparable Mexican tax on the dividend equivalent amount of branch profits or on excess interest of branches of foreign companies. Nevertheless, this Article is drafted reciprocally. Thus, if in future Mexico should adopt such branch taxes, it may apply them to U.S. companies, subject to the same rate limitations that this Article imposes on the United States. In that event the term "trade or business" in reference to Mexico will have the same meaning that the term "permanent establishment" has under Mexican tax law. (See point 15(a) of the Protocol.) (Mexico uses the concept of a "permanent establishment" in its domestic law to determine when a foreign resident's income is subject to Mexican tax. The definition of "permanent establishment" for these purposes, contained in Articles 2 and 3 of the Income Tax Law of Mexico, is similar but not identical to the definition for treaty purposes and, where it differs, is generally broader than the meaning for treaty purposes.)

Article 12. ROYALTIES

This Article limits the taxation at source by each Contracting State of royalties paid to a resident of the other Contracting State.

Paragraph 1 preserves the residence country's general right to tax its residents on royalties arising in the other Contracting State. The same result is achieved by the saving clause of paragraph 3 of Article 1 (General Scope).

Paragraph 2 limits the tax imposed by the source State to not more than 10 percent of the gross amount of royalties beneficially owned by residents of the other State. In the absence of a treaty, the U.S. rate is 30 percent, and the Mexican rates are 15 percent on literary copyrights and films and drawings and 35 percent on other royalties. The Mexican rate on equipment rentals is 21 percent in general and 5 percent on container rentals. (In this Convention, equipment rentals are treated as giving rise to royalties and container rentals are dealt with in Article 8 (Shipping and Air Transport)).

In applying the assets tax to income covered by this Article, Mexico agrees to credit the amount of income tax that would have been due at the statutory rates, rather than at the

reduced treaty rates. The resulting credit, generally of 21 percent of the gross income, is expected to eliminate any asset tax liability in such cases. If no royalty is paid on account of the use of the property, then there would be an asset tax liability because there would be no income from the property ???? income tax to credit.

Paragraph 3 defines the term "royalties", as used in the Convention, to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including films, tapes and other means of reproduction for use in connection with television. The term "copyright" is understood to include the use or right to use computer software programs and sound recordings. Royalties also include payments for the use of, or right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, for information concerning industrial, commercial, or scientific experience, and for the use of or right to use industrial, commercial or scientific equipment. However, payments for the use of equipment covered by Article 6 (Immovable Property), such as equipment used in agriculture or forestry, are covered by that Article. Payments for the leasing of containers used in international transport and payments for certain leasing of ships and aircraft used in international transport are covered by Article 8 (Shipping and Air Transport). In financial leases, if the interest component is identified separately in the contract, Mexico taxes only the interest component and applies the relevant rate from Article 11 (Interest).

Point 11 of the Protocol clarifies that the reference to "information concerning industrial, commercial or scientific experience" is to be interpreted in accordance with paragraph 12 of the Commentary on Article 12 of the OECD Model, which distinguishes between information as embodied in know-how and the performance of technical services.

The definition of royalties also includes gains from the alienation of any royalty-producing right or property that are contingent on the productivity, use, or disposition of the property; as a consequence, such amounts may be taxed at source in accordance with this Article rather than being exempt from tax at source under Article 13 (Capital Gains).

Paragraph 4 provides an exception to paragraphs 1 and 2 in cases where the beneficial owner of the royalties, who is a resident of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base in that other State and the royalties arise in that other State and are attributable to that permanent establishment or fixed base. In such a case, the royalties are taxable to the permanent

establishment or fixed base in accordance with the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services). This rule applies even if the permanent establishment or fixed base no longer exists when the royalties are received, as long as the royalties were attributable to the permanent establishment or fixed base when earned.

Paragraph 5 provides that, if, as a result of a special relationship between persons, the amount paid is excessive, Article 12 applies only to the amount that would have been paid absent such special relationship (i.e., an arm's length royalty payment). Any excess amount of royalties paid remains taxable according to the laws of the source State, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of profits under the source State's law, such excess amount will be taxed as a dividend rather than as a royalty payment, but the tax imposed on the dividend payment will be subject to the rate limitations of paragraphs 2 and 3 of Article 10 (Dividends).

Paragraph 6 provides a source rule. Royalties are, in the first instance, deemed to arise in a Contracting State if paid by a resident of that State, including the State itself, unless the royalties are borne by a permanent establishment or a fixed base in the other Contracting State, in which case the source is that other State. Royalties in general are considered borne by a permanent establishment or fixed base if deductible in computing the taxable income of that permanent establishment or fixed base If royalties are neither paid by a resident of either State nor borne by a permanent establishment or fixed base in either State but they relate to the use of a right or property in one of the Contracting States, the source will be in the State where the right or property is used. For example, if a Mexican resident were to license a patent to a resident of Panama for use in the United States, the royalty paid by the Panamanian licensee to the Mexican owner of the patent would be U.S. source income under this Article, subject to the 10 percent rate provided in paragraph 2.

Article 13. CAPITAL GAINS

This Article provides rules governing when a Contracting State may tax capital gains derived by a resident of the other Contracting State.

Paragraph 1 provides that each State may tax gains on the alienation of immovable property situated in that State. The Convention does not interfere with the domestic law rules on the taxation of such gains, other than to require nondiscriminatory treatment under Article 25 (Non-Discrimination).

Paragraph 2 elaborates on the rule of paragraph 1 by explaining that "immovable property" includes not only such property held directly, but also an interest in a partnership, trust or estate to the extent that its assets consist of real property, shares or comparable interests in a legal person if at least 50 percent by value of the assets of that legal person consist (or consisted) of immovable property, and any other right that confers the use or enjoyment of immovable property. Thus, for example, the sale of time shares for the use of vacation property in a Contracting State could give rise to a gain taxable by that State under this Article. Point 12 of the Protocol confirms that, in the case of the United States, immovable property includes a U.S. real property interest.

Paragraph 3 provides that gain from the alienation of personal property comprising part of the assets of a permanent establishment or fixed base that a resident of one Contracting State has or had in the other Contracting State may be taxed by the State where the permanent establishment or fixed base is or was located. This rule preserves the U.S. tax imposed by Code section 864(c)(7) with respect to gain from the subsequent disposition of assets that were formerly used in a U.S. trade or business, except that the treaty substitutes a permanent establishment threshold.

Paragraph 4 provides a rule that, together with point 13 of the Protocol, is similar to the corresponding provision in the U.S.-Spain income tax treaty. It permits Mexico to continue to impose its tax on the gain derived by U.S. residents on the alienation of shares in Mexican companies or other legal entities, but limits that tax to cases where the person disposing of the shares had a direct or indirect participation of at least 25 percent in the capital of the Mexican company or other legal entity at any time during the 12 months preceding the disposition. Point 13 of the Protocol further limits imposition of this tax in certain corporate reorganizations. The tax permitted by paragraph 4 may not be assessed in cases of transfers within a consolidated group when (i) both transferor and transferee are residents of the same State, (ii) there is an 80 percent or more ownership interest (direct or indirect) between the transferor and transferee or of the transferor and the transferee by another resident company before and after the transfer, (iii) the transferee carries over the transferor's basis, and (iv) the transferor receives an equity interest in the transferee or in another company that owns at least 80 percent of the transferee. In such cases the tax on the gain is deferred until the shares or other property are transferred outside the group. These rules do not perfectly parallel the U.S. rules for tax-free reorganizations. Rather, they establish standards, solely for purposes of the Convention, for limiting tax on intercompany transfers.

The United States will treat gain taxed by Mexico under this paragraph as of Mexican source to the extent necessary to permit a credit for the Mexican tax, subject to the limitations of U.S. law (Code section 904). Thus, if the Mexican tax does not exceed the U.S. tax, there will be a full offset. Under Mexican law, the taxable gain is measured as the difference between 1) the sale price of the shares and 2) the original cost of the shares, adjusted for inflation, plus reinvested profits, also adjusted for inflation, less any losses. Any excess of the sale price over that adjusted basis is considered gain attributable to untaxed profits and is subject to Mexican tax.

Paragraph 4 is reciprocal. If the United States were to introduce such a tax, it could be imposed in accordance with the rules of this paragraph.

Paragraph 5 provides that gains derived by an enterprise carried on by a resident of one of the Contracting States from the alienation of ships, aircraft, containers or related equipment used principally in international traffic may be taxed only by that State. This is intended to achieve the same result as the corresponding language in the 1981 U.S. Model. The reference to property used "principally" in international traffic simply clarifies that an occasional use in domestic traffic does not cause the disposition to fall outside the scope of this provision.

Paragraph 6 confirms that contingent gains, described in paragraph 3 of Article 12, (Royalties), are covered in that article and not in this one.

Paragraph 7, like the corresponding provision in the 1981 Model, reserves the exclusive right to tax gains with respect to any other property to the State of which the alienator is a resident.

Article 14. INDEPENDENT PERSONAL SERVICES

This Article deals with income from self-employment services and Article 15 deals with the compensation of employees. Articles 16, 18, 20 and 21 provide exceptions to the general rules of Articles 14 and 15 in the case of personal service income derived by directors of companies (Article 16), entertainers and athletes (Article 18), government employees (Article 20), and students and business apprentices (Article 21). Like the U.S. and OECD Models, the Convention does not provide a separate rule for the remuneration of teachers. The compensation of teachers and researchers is taxable under this Article or Article 15 (Dependent Personal Services), as appropriate.

Income derived by an individual who is a resident of one Contracting State from the performance of personal services in an

independent capacity in the other Contracting State is exempt from tax in that other State unless one of two conditions is satisfied. The income may be taxed in that other State if the income is for services performed there and is attributable to a fixed base that the individual regularly uses in that other State and in performing the services. Alternatively, if the individual is present in that other State for more than an aggregate of 183 days in twelve consecutive months, that other State may tax the income attributable to the activities performed there, whether or not there is a fixed base. It is understood that the concept of a fixed base is to be interpreted consistently with the concept of a permanent establishment, as defined in Article 5 (Permanent Establishment). Under either the fixed base or 183 day presence test, it is understood that the taxation of income from independent personal services is to be governed by the principles set forth in Article 7 for the taxation of business profits. Thus, for example, it is understood that income may be attributed to a fixed base even after the fixed base has ceased to exist or to personal services in a year after the year in which they were performed. In addition, in accordance with the principles of paragraph 3 of Article 7, the tax base is net of expenses incurred in earning the income.

There is a rebuttable presumption in Mexican law that, when services are paid for by a resident of Mexico and were partly performed in Mexico, the entire payment is for services performed in Mexico. If part of the services were performed outside Mexico, it is the taxpayer's responsibility to so demonstrate.

Paragraph 2 notes that the term "independent personal services" is primarily concerned with professional services. It includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list, which is derived from the OECD Model, is not exhaustive. The term includes all personal services performed by an individual for his own account where he receives the income and bears the risk of loss arising from the services.

Point 14 of the Protocol further provides that Article 14 also applies to independent services furnished in Mexico by a U.S. company, in which case the income will be taxed as if it were attributable to a permanent establishment in Mexico. In the converse case, the United States will apply Article 7 (Business Profits) directly. However, under Mexican rules, a personal service company is not considered to earn "business" profits, so it is taxed under Article 14. The Protocol confirms that the tax will be imposed on a net basis.

Article 15. DEPENDENT PERSONAL SERVICES

This Article deals with the taxation of remuneration derived by a resident of a Contracting State from the performance of personal services as an employee in the other Contracting State.

Under paragraph 1, remuneration derived by an employee who is a resident of a Contracting State may be taxed only by his State of residence except to the extent that it is derived from an employment exercised in the other Contracting State. Remuneration derived from employment in the other State may also be taxed by that other State, subject to the conditions specified in paragraph 2.

Under paragraph 2, a Contracting State may tax remuneration derived by a resident of the other State from services performed in the first State unless three conditions are satisfied: (1) the individual is present in that State for a period or periods not exceeding 183 days in twelve months; (2) the remuneration is paid by, or on behalf of an employer who is not a resident of that Contracting State; and (3) the remuneration is not borne as a deductible expense by a permanent establishment or fixed base that the employer has in that State. The twelve month period must include the period in which the income was earned. All three conditions must be satisfied for the remuneration to be exempt from tax in the source State. If a foreign employer pays the salary of an employee, but a host country corporation or permanent establishment reimburses the foreign employer and deducts such reimbursement, neither condition (2) nor (3), as the case may be, will be considered to have been fulfilled. Conditions (2) and (3) are intended to assure that a Contracting State will not be required both to allow a deduction to the payor for the amount paid and to exempt the employee on the amount received.

Unlike the U.S. and OECD Models, this Convention does not provide a special rule for the taxation of members of the crew of international airlines and shipping companies. They are taxable in accordance with the provisions of paragraphs 1 and 2.

Article 16. DIRECTORS' FEES

This Article provides that a Contracting State may tax the fees paid by a company that is a resident of that State to a resident of the other Contracting State for services as a director or overseer of the company, if the services are performed in the first State or in any third State. The reference to an "overseer" is meant to include persons who are not directors but who oversee, i.e. look out for, the shareholders' interests without engaging in day to day management functions. Mexican corporations frequently hire such persons.

This rule is a compromise between the positions of the OECD Model, which permits the taxation of such fees in accordance with

domestic law, and the U.S. Model, which treats such fees as employment income under Articles 14 (Independent Personal Services) or 15 (Dependent Personal Services). In this case, Mexico is permitted to tax such fees paid by a Mexican company to its U.S. resident directors or overseers, provided that the services are performed outside the United States. As a consequence, the director or overseer will have foreign source income against which to credit the Mexican tax. Notwithstanding this Article, the United States will tax directors' fees for personal services rendered by Mexican resident directors of U.S. corporations only to the extent that the services are performed in the United States (and the remuneration is therefore sourced in the United States). Mexico generally taxes such fees whenever the paying company is a resident of Mexico.

Article 17. LIMITATION ON BENEFITS

Article 17 assures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State who have a substantial presence in, or business nexus with, that State. Absent this Article, if a resident of a third State were to organize a corporation in a Contracting State for the purpose of deriving treaty-benefitted income from the other Contracting State, the entity would generally be entitled to benefits as a resident of a Contracting State, subject to any limitations imposed by the domestic law of the source State (e.g., business purpose, substance-over-form, step transaction or conduit principles).

The structure of the Article is as follows: Paragraph 1 lists a series of attributes of a resident of a Contracting State the presence of any one of which will entitle that person to benefits of the Convention in the other Contracting State. Subparagraphs d) iii) and g) of paragraph 1 expand the usual list of such attributes to extend benefits of the Convention to residents of a Contracting State that are partly owned by residents of any country that is a party to the North American Free Trade Agreement ("NAFTA"; currently, the parties are the United States, Mexico, and Canada) once that agreement enters into force. Paragraph 2 further provides that benefits may be granted to a person not entitled to benefits under the tests of paragraph 1 if the competent authority of the source State determines that it is appropriate to provide benefits in that case. Point 15 of the Protocol defines certain terms and conditions of the Article.

The first category of residents of a Contracting State eligible for treaty benefits from the other Contracting State consists of individuals. It is unlikely that individuals can be used to derive treaty-benefitted income on behalf of a third-country person, because the articles of the Convention providing

such benefits require that the beneficial owner of the income, not just the recipient, be a resident of a Contracting State.

The second category of qualifying residents is comprised of the Contracting States themselves or political subdivisions or local authorities thereof.

The third category consists of businesses that are engaged in the active conduct of a trade or business in the residence State and derive income from the other Contracting State in connection with, or incidental to, that trade or business. For this purpose, the business of making or managing investments is not considered an active business unless carried on by a bank or insurance company as part of its banking or insurance activities. Point 15 a) of the Protocol explains that the term "trade or business," in the case of Mexico, refers to a permanent establishment as defined in Mexico's Income Tax Law. As described in the discussion of Article 11A (Branch Tax), Mexican domestic law uses the term "permanent establishment" in a way that is analogous to the use of the term "trade or business" under U.S. tax law and that differs from the meaning of that term under the Convention.

The fourth category consists of companies whose shares are regularly traded in substantial volume on an officially recognized securities exchange (hereafter referred to as "publicly traded"). Point 15 b) of the Protocol defines "recognized securities exchange". It currently covers U.S. and Mexican exchanges, but permits the competent authorities to agree on additional exchanges. It would be appropriate, for example, to add Canada's exchanges to implement the provisions of part (iii) of subparagraph d).

Three sub-categories of publicly traded corporations are provided in subparagraph d). Under the first, a company qualifies as a resident entitled to benefits of the Convention if its principal class of shares is publicly traded on a recognized securities exchange in either Mexico or the U.S. Second, it will qualify if, although its own shares are not publicly traded, it is the wholly owned subsidiary (through direct or indirect ownership) of a company that is a resident of the same State and whose shares are so traded. Thus, for example, a Mexican company not publicly traded but wholly owned by a holding company that is a resident of Mexico whose shares an publicly traded on a recognized exchange in the United States or Mexico and is publicly traded, will qualify under subparagraph d)(ii). The third alternative permits a company that is not publicly traded to qualify if it is more than 50 percent owned, directly or indirectly, by one or more companies that are residents of the United States and/or Mexico and the remainder of its ownership is by publicly traded companies that are residents of any country that is a party to the ("NAFTA") (i.e. currently Canada). Thus,

for example, a Mexican company will qualify if it is owned 51 percent by publicly traded U.S. and/or Mexican companies and 49 percent by a publicly traded Canadian company. This alternative does not take effect until the NAFTA is in force. (Protocol, point 15 d).

The fifth category covers tax exempt organizations, if more than half of the beneficiaries, members, or participants, if any, are individual residents of either Contracting State or other persons who qualify for the benefits of this Convention under the terms of this Article.

Subparagraphs f) and g) establish a sixth category of residents that are entitled to benefits of the Convention if they satisfy one of two alternative two part tests regarding ownership and "base erosion." The rationale for these tests is that, while substantial ownership of the equity of the resident entity by qualifying persons tends to demonstrate an entitlement to benefits of the Convention, it is not sufficient to prevent treaty benefits from inuring substantially to third-country residents. It is also necessary to ensure that the earnings of such entity not be "stripped" out in substantial part to non-qualifying persons, for example by financing the entity largely through third-country debt. In most U.S. Conventions, only one such provision is included. In this case, a second alternative is provided in recognition that one of the expected results of the NAFTA is to encourage joint ventures among residents of the three member countries.

Under the ownership requirement of the first alternative, benefits will be granted to a resident of a Contracting State if more than 50 percent of the beneficial interest in the person (or, in the case of a company, more than 50 percent of each class of its shares) is owned, directly or indirectly, by persons who are themselves entitled to benefits under the tests of paragraph 1 other than subparagraph (c). Subparagraph (c) refers to active businesses and the "safe harbor" it provides is meant to be limited to income earned by the active trade or business, not to cover other income earned by a subsidiary of such a business.) In addition, the "base erosion" standard must be satisfied. Less than 50 percent of the person's gross income may be used, directly or indirectly, to make deductible payments, including interest and royalties, to persons not eligible for benefits under the tests of paragraph 1 other than subparagraph (c)). For this purpose "gross income" means gross receipts or, in the case of a manufacturing or producing activity, gross receipts less the direct costs of labor and materials. (See paragraph 15 (c) of the Protocol.)

Alternatively, once NAFTA is in force the benefits of the reduced rates on dividends, interest, branch profits and excess interest, and royalties provided, respectively, in Articles 10,

11, 11A, and 12, will also be available to an entity which is (i) more than 30 percent beneficially owned by residents of either Mexico or the United States who are themselves entitled to benefits under the tests of paragraph 1 (other than those who qualify only under the active business test of subparagraph c)) and (ii) more than 60 percent beneficially owned by residents of NAFTA member states, provided that, (iii) less than 70 percent of the gross income of such person is used to meet liabilities to persons other than those described under (i) above and less than 40 percent of the gross income is used to meet liabilities to persons other than those described under (i) or (ii) above. It is understood that the definition of "gross income" in paragraph 15(c) of the Protocol applies for this provision also. For this purpose, ownership by residents of a NAFTA State other than the United States and Mexico (currently Canada) will be taken into account only if (i) that other NAFTA State has a comprehensive income tax treaty with the country of source of the dividend, interest, branch profit or excess interest, or royalty; (ii) such treaty provides for a rate of tax no less favorable than that provided by this Convention with respect to the same item of income; and (iii) the resident of the NAFTA State qualifies for the benefits of that treaty under its terms (e.g. its limitation on benefits provision). For example, assume a Mexican company is beneficially owned 40 percent by residents of Mexico and 60 percent by residents of Canada, and meets the base erosion test of this provision. If such a company derives dividends from the United States, it will not be entitled to the benefits of Article 10 of this Convention, because the current U.S.-Canada treaty provides for higher rates on both portfolio and direct investment dividends. If, however, that company derives interest on credit sales of equipment to unrelated U.S. persons, or royalties of any kind from U.S. sources, it will be entitled to the benefits of this treaty, because it could have obtained at least as favorable a tax rate under the U.S.-Canada income tax treaty. As in the case of subparagraph d), concerning the publicly traded test, this partial "derivative" benefits rule of subparagraph g) only takes effect when the NAFTA is in force. (Protocol, point 15(d).)

It is intended that the provisions of paragraph 1 will be self executing. Unlike the provisions of paragraph 2, discussed below, claiming benefits under this paragraph does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the tax-payer has improperly interpreted a particular subparagraph and is not entitled to the benefits claimed.

Paragraph 2 permits the competent authority of the State in which income arises to grant treaty benefits in additional cases, even if they do not meet the safe harbor standards of paragraph 1 (or the information is not available to make such a determination). This discretionary provision is included in recognition

that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a Contracting State is warranted by sound business practice and does not indicate a motive of attempting to derive unintended treaty benefits.

Article 18. ARTISTES AND ATHLETES

This Article deals with the taxation of remuneration derived by artistes (i.e. performing artists and entertainers) and athletes who are residents of a Contracting State from the performance of their services as such in the other Contracting State. As explained in point 16 of the Protocol, such remuneration includes remuneration for personal activities relating to the individual's reputation as an entertainer or athlete, such as compensation for services performed in personal endorsements of commercial products. This Article does not apply to the remuneration of other persons involved in a performance or athletic event, such as technicians, managers, or coaches.

Paragraph 1 overrides the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services) to provide that an individual covered by this Article who would be exempt from tax in the State where the services are performed under the terms of Articles 14 or 15 may, nevertheless, be taxed in that State if the gross remuneration, including reimbursed expenses, exceeds U.S. $3,000 or its equivalent in Mexican currency during the taxable year. Anyone receiving more than the $3,000 gross income amount is subject to tax on the full amount, in accordance with the provisions of domestic law of the source country. Since it is often difficult to determine the annual amount of remuneration until the year has ended, the paragraph explicitly authorizes a tentative withholding of tax. Individuals entitled to exemption under this paragraph may claim a refund, and those subject to tax may apply the withholding against their final tax liability.

This represents a compromise between the position of the OECD and UN Models, which provide for immediate taxation at source of entertainers and athletes, and the 1981 U.S. Model, which seeks to preserve a threshold of gross income below which modestly paid entertainers and athletes will be treated the same as persons performing other services covered solely under Articles 14 or 15. In this case, the threshold is lower than in the 1981 U.S. Model. However, paragraph 3 of this Article provides a special exemption at source of the remuneration of entertainers or athletes whose visit is substantially supported by public funds of their State of residence or a political subdivision or local authority thereof. It is understood that the competent authorities may consult as to which visits meet this standard.

Paragraph 2 is intended to deal with the potential for abuse when income from a performance accrues to a person other than the performer. For example, an entertainer performing as an "employee" of a closely held company not having a permanent establishment in the source State may be able to avoid tax at source by taking a salary below the threshold amount and diverting the remainder to a company of which he is the sole or principal owner. Paragraph 2 provides that, when an entertainer or athlete retains a beneficial interest in income that derives from his personal activities but accrues to another person, that other person may be subject to taxation on such income by the State of source, notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services) and 15 (Dependent Personal Services). For purposes of this paragraph, an entertainer or athlete is considered to retain a beneficial interest in performance income accruing to another person unless the individual can establish that neither he nor any person related to him participates, directly or indirectly, in the profits of such other person in any manner.

As mentioned above, paragraph 3 provides an independent exemption from taxation at source of the remuneration of entertainers and athletes whose visits are substantially supported by public funds of their country of residence or a political subdivision or local authority thereof.

Article 19. PENSIONS, ANNUITIES, ALIMONY, AND CHILD SUPPORT

Except as provided in Article 20 (Government Service), pensions and similar remuneration in consideration of past employment may be taxed only by the Contracting State of which the beneficial owner is, at the time of receipt, a resident. It is understood that the services need not have been performed by the beneficial owner of the pension; for example, a pension paid to a surviving spouse who is a resident of Mexico would be exempt from tax by the United States on the same basis as if the right to the pension had been earned directly by the surviving spouse. A pension may be paid in installments or in a lump sum.

In contrast, except as provided in Article 20 (Government Service), social security benefits and other public pensions paid by a Contracting State may be taxed only in the paying State. This rule is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a Mexican social security benefit will be exempt from U.S. tax even if the beneficiary is a U.S. resident or a U.S. citizen (whether resident in the United States, Mexico, or a third country).

Annuities derived and beneficially owned by an individual resident of a Contracting State may be taxed only by that State. This provision is intended to cover traditional annuity arrangements which provide retirement benefits to individuals.

It is not intended to exempt from tax at source income from arrangements that are a variation of traditional annuities and that accrues to corporations or other legal persons.

Alimony and child support payments made by a resident of one Contracting State to a resident of the other State may be taxed only in the State of which the payor is a resident. This rule is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a U.S. resident deriving alimony or child support payments from a resident of Mexico will be exempt from U.S. tax on such payments. Under U.S. law, child support payments are not taxable to the recipient (and not deductible to the payer), while alimony payments are taxable to the recipient (and deductible by the payer). Under Mexican law, neither alimony nor child support payments are deductible to the payer or taxable to the recipient. Thus, under the Convention, child support payments by a resident of one Contracting State to a resident of the other State will be taxable to the payer (in the form of no deduction) and exempt from tax to the owner in both countries. Alimony paid by a resident of Mexico to a resident of the United States will be taxed in Mexico (again by disallowing a deduction to the payer). In the converse case, alimony that is deductible by the U.S. payer (under U.S. law will be subject to U.S. tax to the recipient, and exempt from tax in Mexico.

Article 20. GOVERNMENT SERVICE

This Article follows the corresponding provisions of the OECD Model.

Paragraph 1 provides that payments by a Contracting State or political subdivision or local authority thereof to compensate an individual for performing governmental services may be taxed only in that State, provided that the individual is not a resident and national of the other Contracting State and was not a resident of the other Contracting State prior to performing the services. Under subparagraph b), if the individual is either a resident and national of the other State or a locally hired resident of that other State, the compensation may be taxed only by that other State. It is understood, however, that the rule of sub-paragraph (b) does not apply to the spouse of a government employee described in paragraph 1 if the spouse becomes employed by the sending State after taking up residence in the host state.

Paragraph 2 provides rules for the taxation of pensions paid from public funds in respect of governmental services. Such pensions may be taxed only by the paying State unless the individual recipient is a resident and citizen of the other State, in which case only the other (residence) State may tax the pension. This rule does not apply to social security benefits and other public pensions which are not in respect of services rendered to the paying government or a political subdivision or

local authority thereof; such amounts may be taxed only by the paying State under Article 19. However, this rule does apply to social security payments to U.S. Government employees for whom the social security system is the retirement plan related to their government service; i.e., in the unusual case where an individual who is a citizen and resident of Mexico derives a pension for U.S. Government employment that is paid under the social security system, only Mexico may tax that pension. This could happen, for example, if a locally hired driver for the U.S. Embassy in Mexico City were to retire in Mexico and receive U.S. social security benefits.

The rules of paragraphs 1 and 2 are an exception to the saving clause of paragraph 3 of Article 1 (General Scope) for individuals who are neither citizens nor permanent residents of the State where the services are performed. Thus, for example, payments by Mexico to its employees at the Mexican Embassy in Washington are exempt from U.S. tax if the employees are not U.S. citizens or green card holders and were not residents of the United States at the time they became employed by Mexico, even if they would otherwise be considered U.S. residents for tax purposes. (Under the 1984 modification to the definition of a U.S. resident in Code section 7701, this exception to the saving clause is of less relevance, since time spent in the United States as a foreign government employee does not count in applying the physical presence test of residence.)

Paragraph 3 provides that remuneration and pensions paid in respect of services performed for a government in the conduct of a business are covered by Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 16 (Directors' Fees), 18 (Artistes and Athletes), or 19 (Pensions, Annuities, Alimony, and Child Support), as appropriate. It is understood by both sides that this Article applies only to remuneration and pensions in respect of services rendered in the discharge of functions of a governmental nature.

Article 21. STUDENTS

This Article deals with visiting students and business apprentices and corresponds to the provision of the OECD model. An individual who is a resident of one of the Contracting States and who visits the other Contracting State solely for the purpose of acquiring education or training, will not be taxed by that other State on amounts received from abroad to cover his expenses. The reference to "solely" for the purpose of education or training is meant to describe individuals participating in a full time program of study or training. It is not intended to exclude full-time students who, in accordance with their visas, may hold part-time jobs. The exemption, however, does not extend to any amounts received as compensation for services rendered, which are covered under Article 14 (Independent Personal

Services) or Article 15 (Dependent Personal Services). The exemption also does not apply to any grant provided from within the host State, which is taxable in accordance with the domestic law of that State.

This Article is an exception to the saving clause of paragraph 3 of Article 1 (General Scope) for individuals who are not citizens of the United States or green card holders but are residents of the United States under the physical presence tests of Code section 7701 (b).

ARTICLE 22. EXEMPT ORGANIZATIONS

This Article provides for reciprocal recognition of tax-exempt, charitable organizations resident in a Contracting State and qualifying for benefits of the Convention under Article 17, paragraph 1 e) or 2. The effect of the reciprocal recognition is to exempt from source taxation income earned by a charitable organization resident in the other Contracting State and to permit deductions for cross-border charitable donations. In addition, the U.S. will recognize qualifying Mexican charities as "public charities." Thus, for example, a contribution to those charities by a U.S. private foundation will not constitute a "taxable expenditure" under section 4945 of the Code; as a result, the U.S. private foundation will not be required to exercise so-called "expenditure responsibilities" with respect to such contributions.

The provisions of this Article are exceptions to the saving clause of paragraph 3 of Article 1 (General Scope) in that they call for certain treatment by a Contracting State of its own citizens or residents. Thus, both States are required, even when domestic law would not do so, to permit a deduction to their citizens or residents for contributions to the other State's exempt organizations that are recognized as charitable under the Convention.

The provisions of Article 22 were considered a desirable way to encourage contributions by U.S. residents to small Mexican charities that would have difficulty in organizing a U.S. entity through which contributions could be directed, or in satisfying the administrative requirements for recognition as a foreign corporation eligible for treatment as a "public charity" in the United States. Article 22 also enables taxpayers living and operating at the border to support organizations across the border from which they derive benefits. The physical, proximity of Mexico and the United States provides a unique circumstance for the reciprocal recognition of tax-exempt organizations.

Paragraph 1 provides that a tax-exempt organization resident in a Contracting State that is operated exclusively for religious, scientific, literary, educational, or other charitable

purposes will be exempt from income tax in the other Contracting State on items of income that would be exempt from tax in the other Contracting State, under its laws, if the organization were recognized by that other State as being entitled to exemption from tax. Under Paragraph a) of Point 17 of the Protocol, the competent authorities of each Contracting State will accept the certification of the other State as to the status of a resident of that other State as an organization exempt from tax.

Paragraph 2 sets the standards for deductibility of contributions by a resident of the U.S. to a charitable organization resident in Mexico. It provides that if the Contracting States agree that Mexico's standards for organizations authorized to receive deductible contributions are essentially equivalent to the United States' standards for status as a public charity, then an organization that Mexico determines has met its standards shall be treated as a public charity in the United States for two purposes: (1) receiving grants from United States private foundations and (2) receiving deductible charitable contributions from residents or citizens of the United States. In 1992, Mexico adopted standards for the tax-exemption of charitable organizations that are modeled on United States tax laws governing exempt organizations. Paragraph b) of Point 17 of the Protocol reflects that the United States has examined Mexico's new standards for organizations authorized to receive deductible contributions, contained in Article 70-B of the Mexican Income Tax Law, and determined that those standards are essentially equivalent to the United States' standards for public charities. Thus, although paragraph 2 is not itself self-executing, the Protocol brings its provisions into effect immediately upon entry into force of the Convention. However, the United States competent authority retains the right, after consultation with the competent authority of Mexico, to deny the benefits of paragraph 2 to an organization resident in Mexico even though the tax authorities of Mexico have found that the organization qualifies under Article 70-B, if the circumstances of a case or cases warrant. Mexican and U.S. tax administrators also expect to continue to cooperate to provide common guidance for taxpayers and common enforcement standards.

The deductibility of a contribution by a U.S. taxpayer to a Mexican charitable organization is subject to the limitations under U.S. law applicable to contributions to U.S. public charities. These limitations include, in particular, the percentage and other limitations under Code section 170 and the overall limitation on itemized deductions under Code section 68. The amount of the deduction for a U.S. taxpayer's contributions to Mexican charities is limited to the U.S. taxpayer's Mexican source income, as determined under the Convention, and the general limitations under U.S. law (for example, the percentage limitations of section 170) are applied to this amount. Any amounts treated as charitable contributions under this paragraph

that are in excess of the amounts deductible in a taxable year may be carried over and deducted in subsequent taxable years subject to the limitations of this paragraph.

Paragraph b) of Point 17 of the Protocol also reflects that Mexico has reviewed the U.S. standards for publicly supported organizations under sections 509 (a)(1) and (2) of the Code and determined that they are essentially equivalent to Mexico's standards for organizations authorized to receive deductible contributions. This conclusion does not, however, pertain to religious organizations, which, although eligible for charitable status in the U.S., are not entitled to receive deductible contributions under Mexican law.

Paragraph 3 provides rules for purposes of Mexican taxation with respect to the deductibility of gifts to a U.S. resident organization by a resident of Mexico. The rules of paragraph 3 parallel the rules of paragraph 2.

Paragraph 4 provides an exemption from U.S. excise taxes on private foundations in the case of religious, scientific, literary, educational or other charitable organization that is a resident of Mexico and which has received substantially all its support from persons other than citizens or residents of the United States. These excise taxes are generally imposed by Chapter 42 of subtitle D of the Code. To claim benefits under this paragraph a Mexican non-profit organization must also meet the requirements of paragraph 1(e) or 2 of Article 17 (Limitation on Benefits).

Article 23. OTHER INCOME

This Article provides the rules for the taxation of items of income derived by a resident of a Contracting State from sources in the other Contracting State that are not dealt with in the other articles of the Convention, such as lottery winnings, punitive damages, cancellation of indebtedness income, [income from financial products such as swaps, and forward and futures contracts]. Such income may be taxed in the State in which it arises. Income arising in a third State is not dealt with in this Article. This domestic laws apply, unless the income constitutes business profits of a permanent establishment or fixed base of a resident of the other Contracting State, in which case Article 7 (Business Profits) or 14 (Independent Personal Services) applies.

Article 24. RELIEF FROM DOUBLE TAXATION

In this Article each Contracting State undertakes to relieve double taxation by granting a credit against its income tax for the income tax paid to the other country. It also provides a credit to a parent company (one owning at least 10 percent of the

voting stock of a company which is a resident of the other State) for tax "indirectly" paid to that other State on the portion of the profits distributed as dividends to its parent company. The credit is subject to the limitations of domestic law, such as Code section 904 in the case of the United States.

For purposes of paragraph 1, the taxes referred to in paragraphs 3 and 4 of Article 2 (Taxes Covered) shall be treated as income taxes, and therefore eligible for the credit. However, Mexico's tax on distributed profits is considered to be an income tax only to the extent that it is imposed on previously untaxed earnings and profits as calculated under U.S. tax accounting rules. The distributed profits tax is imposed by Mexico to ensure that the full tax has been paid at the corporate level, since no further tax is collected from the shareholder on profits distributed as dividends. The tax is imposed on the corporation, at the regular corporate rate, on the amount of a distribution that exceeds the corporate income previously subject to tax. By agreeing to credit the tax only to the extent it is imposed on earnings and profits as calculated for U.S. purposes, the U.S. seeks to ensure that creditability is consistent with prevailing U.S. principles, which only permit credits for those foreign taxes that reach net income. Because Mexico's tax on distributed profits is imposed on the corporation, not the shareholder, it is creditable as an "indirect" or "deemed paid" tax under the principles of Code section 902. The amount of the distributed profits tax deemed paid and credited in accordance with this Article will be treated as a dividend for purposes of the Code section 78 "gross-up."

Paragraph 2 provides that, to the extent that the provisions of the Convention require Mexico to exempt from tax income derived by its residents, it will use the exemption rather than the credit method of avoiding double taxation. In such cases Mexico may take into account the residents' entire income, including the exempt amount, in calculating the applicable tax rate to be applied to the taxable portion. Thus, the exemption is calculated at the average rate of tax on total income, rather than at the rate applicable to the lowest or highest applicable bracket of income. This approach is sometimes referred to as "exemption with progression" and is commonly used by countries that avoid double taxation by exempting foreign source income.

Paragraph 3 provides that, for purposes of this Article, income which may be taxed in a Contracting State under the terms of this Convention will be considered to have its source in that State. However, domestic law source rules that apply for purposes of limiting the foreign tax credit will govern if they differ from the rules resulting from the treaty source rules. This permits the United States to apply the anti-abuse rules of Code section 904(g), for example. An exception is made in the case of capital gains; to the extent that gains that would be

U.S. source under the Code are re-sourced as Mexican source income under the Convention, the Convention source rule prevails, subject to the separate basket requirement of Code section 904(g)(10). Paragraph 4 of Article 13 (Capital Gains) resources domestic source capital gains as foreign source to the extent necessary to avoid double taxation under the taxing rules of that paragraph.

Paragraph 4 provides a special rule to avoid double taxation of residents of Mexico who are U.S. citizens. The United States, in such cases, is entitled to tax under its statutory rules, without respect to the treaty limitations that apply to residents of Mexico who are not U.S. citizens. In such cases, the United States agrees that Mexico, in imposing its tax based on residence, is required to credit only the U.S. tax that would have applied to the U.S. source income of a resident of Mexico who is not a U.S. citizen. The United States agrees to credit Mexico's tax (net of that credit) against its residual tax imposed on the basis of citizenship, and to resource enough U.S. source income as Mexican source to prevent double taxation of that income. For example, assume a U.S. citizen resident in Mexico has $700 of Mexican income and $300 of U.S. dividends. Assume that the U.S. tax rate is 30 percent and the Mexican tax rate is 35 percent. The U.S. tax is 300 less a credit of 210 (70% of 300), a net tax of 90. The Mexican tax is 350, less a credit for U.S. tax at the 15 percent treaty rate on dividends, or 45, a net tax of 305. The total tax will be 390, higher than either country's tax, indicating some double taxation of the U.S. dividends. To remove that double taxation, the U.S. will allow an additional credit for the Mexican tax, but the additional credit may not reduce the U.S. tax after credit below 45 (15% of 300). Thus, the additional credit in this case is 45. The total tax is reduced to 350, the higher of the two countries' taxes. (A similar example can be constructed for cases where there is income from taxes in the other countries result in excess limitation in Mexico, that may absorb some or all of the additional U.S. tax and reduce or eliminate the need for the additional U.S. credit.)

Article 25. NON-DISCRIMINATION

This Article assures nondiscriminatory taxation of similarly situated persons. Paragraph 1 provides that a national of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State which are different from or more burdensome than the taxes and connected requirements imposed upon a national of that other State in the same circumstances. A national of a Contracting State is afforded protection under this paragraph even if the national is not a resident of either Contracting State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same tax treatment in Mexico as a Mexican national

resident in that third country. It is acknowledged, however, that a national of a Contracting State who is subject to taxation of his worldwide income in that State and a national of the other State who is not subject to taxation of his worldwide income in the first-mentioned State are not in the same circumstances. Thus, the United States is not required to provide equal income tax treatment of a U.S. citizen resident in a third country and a Mexican citizen resident in the same third country.

Paragraph 2 of the Article provides that a permanent establishment in a Contracting State of a resident of the other Contracting State may not be less favorably taxed in the first-mentioned State than an enterprise of that first-mentioned State carrying on the same activities. Neither Contracting State is required to provide to residents of the other Contracting State the same personal exemptions and deductions that it provides to its own residents to take account of marital status or family responsibilities.

Section 1446 of the Code imposes on any partnership with income which is effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the Convention, this obligation applies with respect to a Mexican resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraphs 1 and 2 of the Article. No distinction is made between U.S. and Mexican partnerships. The requirement to withhold on the Mexican and not the U.S. partner's share is not discriminatory taxation, but, like other withholding on non-resident aliens, is a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it may otherwise be difficult for the United States to enforce its tax jurisdiction. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a refund.

Paragraph 3 specifies that no provision of the Article will prevent either Contracting State from imposing the branch taxes described in Article 11A (Branch Tax). Nor does the Article prevent Mexico from denying a deduction for presumed expenses related to income from real property to an individual resident of the United States who elects to deduct actual expenses in computing the Mexican tax on such income, as provided for in paragraph 5 of Article 6 (Income from Immovable Property (Real Property)).

Paragraph 4 prohibits discrimination in the allowance of deductions. When a resident of a Contracting State pays interest or royalties or makes other disbursements to a resident of the

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other Contracting State, the first-mentioned Contracting State must allow a deduction for those payments in computing the taxable profits of the enterprise under the same conditions as if the payment had been made to a resident of the first-mentioned State. An exception to this rule is provided in cases where the payment is excessive, as described in paragraph 1 of Article 9 (Associated Enterprises), paragraph 8 of Article 11 (Interest), or paragraph 5 of Article 12 (Royalties). The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons which includes the person incurring the expense.

Paragraph 5 requires that a Contracting State not impose other or more burdensome taxation or connected requirements on a company that is a resident of that State but that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, than the taxation or connected requirements that it imposes on similar resident companies owned by residents of the first-mentioned State or of a third State. It is understood that the U.S. rules that impose tax on a liquidating distribution of a U.S. subsidiary of a Mexican company and the rule restricting the use of small business corporations to U.S. citizens and resident alien shareholders do not violate the provisions of this Article.

Paragraph 6 provides that, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered), the nondiscrimination protection provided by this Article applies to taxes of every kind and description imposed at all levels of government. Customs duties are not considered taxes for this purpose.

The saving clause of paragraph 3 of Article 1 (General Scope) does not apply to this Article, by virtue of the exceptions in paragraph 4(a) of Article 1. Thus, for example, a U.S. citizen who is resident in Mexico may claim benefits in the United States under this Article.

Article 26. MUTUAL AGREEMENT PROCEDURE

This Article provides for cooperation between the competent authorities of the Contracting States to resolve disputes that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention.

Paragraph 1 provides that, where a person considers that the actions of one or both Contracting States will result for him in taxation which is not in accordance with the Convention, he may present his case to the competent authority of his State of residence or citizenship. It is not necessary for a person first

to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities.

Paragraph 2 provides that, if the competent authority of the Contracting State to which the case is presented considers the case to have merit, and if it cannot reach a unilateral solution, it will seek agreement with the competent authority of the other Contracting State to avoid taxation not in accordance with the Convention. However, the case must be brought to the attention of the competent authority of the other State within four and a half years from the due date or the date of filing of the return in that other State, whichever is later. This time limit was introduced to accommodate Mexico's five year limit in which to exercise its audit powers. In order to keep open a case beyond that time, Mexico must be notified in time to have initiated an audit within five years of the later of the due date or the filing date. The treaty ensures that Mexico will be given at least six months advance notice before expiration of the five year period. If a case is brought within that time period and an agreement is reached by the competent authorities, the agreement will be implemented, and any agreed refund made, within 10 years from the later of the due date, the date of filing of the return in that other State, or the time within which the statute of limitations remains open within that other State for applying such treaty agreements. Thus, if domestic law, either currently or in future, permits holding the statute open longer than ten years, the taxpayer will be granted relief within that longer period. Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, time or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax.

Paragraph 3 authorizes the competent authorities to seek to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. Mexico does not wish to include in this paragraph the list of examples found in the U.S. model of the kinds of matters about which the competent authorities may reach agreement. Mexico thought that some of those examples, such as the ability to adjust dollar amounts for inflation or to vary domestic penalties in international cases, would exceed the authority of its competent authority. Nevertheless, it is understood that the competent authorities will attempt to resolve difficulties or doubts about implementing the Convention to the maximum extent permitted.

Paragraph 4 authorizes the competent authorities to communicate with each other directly for these purposes. It is not necessary to communicate through diplomatic channels.

Paragraph 5 provides for an arbitration procedure, to be implemented subsequently by an exchange of diplomatic notes. Point 18 of the accompanying Protocol provides that the competent authorities will consult after the Convention has been in force for three years to decide whether it is appropriate to exchange the notes. One of the key factors for the U.S. competent authority in making that decision will be the U.S. experience under the arbitration provision of the U.S.-Germany treaty, that entered into force in 1991 and contains the first arbitration provision of any U.S. income tax treaty. Subparagraph b) of point 18 of the Protocol provides rules to be followed in the eventual implementation of the arbitration procedure. The competent authorities may supplement and/or modify those provisions, but must conform to their general principles.

This Article represents another exception to the saving clause of paragraph 3 of Article 1; the benefits of this Article are thus available to residents of both Contracting States. (See paragraph 4(a) of Article 1 (General Scope).)

Article 27. EXCHANGE OF INFORMATION

This Article typically provides for the exchange of tax information between the competent authorities of the Contracting States. However, in this case such exchanges of information are authorized in the Tax Information Exchange Agreement ("TIEA") between the U.S. and Mexico that was signed on November 9, 1989 and is currently in effect. The terms of that Agreement will apply for purposes of this Convention also.

If for any reason the TIEA should be terminated, paragraph 2 provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Convention or for administering and enforcing the domestic laws of the Contracting States referred to in Article 2 (Taxes Covered), as long as the taxation under those domestic laws is not contrary to the Convention. Point 19 of the Protocol further provides that, in that case, the Contracting States shall endeavor to promptly conclude a Protocol governing the exchange of information.

The information exchange is not restricted by Article 1 (General Scope). This means that information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For example, if a third-country resident has a permanent establishment in Mexico that engages in transactions with a U.S. resident, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Such information would not be routinely exchanged, but may be requested in specific cases.

Any information received in accordance with this Article will be treated as secret, subject to the same disclosure constraints that apply to information obtained under the laws of the requesting State. Information received may be disclosed only to persons, including courts and administrative bodies, concerned with the assessment, collection, enforcement or prosecution in respect of the taxes to which the information relates, or to persons concerned with the administration of these taxes. The information must be used by these persons in connection with these designated functions. Persons concerned with the administration of taxes, in the United States, include the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies is for use in the performance of their role in overseeing the administration of U.S. tax laws. Information received under this Article may be disclosed in public court proceedings or in judicial decisions.

This Article applies to all national level taxes. Thus, for example, information relating to an estate subject to national level tax or to a national tax on sales or assets could be exchanged for purposes of implementing the Convention or the domestic income tax laws, even if the transaction in question was purely domestic.

Article 28. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

This Article confirms that any fiscal privileges to which diplomatic agents or consular officers are entitled under the general provisions of international law or under special agreements will apply notwithstanding any provisions of this Convention. This provision also applies to residents of both Contracting States, provided that they are not citizens of the other State and, if the United States is the other State, are not green card holders. (See paragraph 4(b) of Article 1 (General Scope.)

Article 29. ENTRY INTO FORCE

This Article provides the rules for bringing the Convention into force and giving effect to its provisions. Paragraph 1 provides that each State will notify the other when its constitutional requirements for the entry into force of the Convention have been completed. The Convention will enter into force on the date of the later of such notifications.

The effective date of the provisions of the Convention concerning taxes on dividends, interest, and royalties imposed in accordance with Articles 10, 11, or 12, depend on whether the Convention enters into force during the first or second half of the calendar year. If it enters into force during the first six months, the effective date of those provisions is with respect to amounts paid or credited on or after the first day of the second

month after the entry into force. If the Convention enters into force later than June 30 of any calendar year, the effective date of those provisions is with respect to amounts paid or credited on or after the first day of the following January.

With respect to all other taxes, the provisions of the Convention will take effect for taxable periods beginning on or after the first of January of the year following the year in which the Convention enters into force.

Once the provisions of this Convention take effect, as provided in paragraph 2 b), the provisions of the exchange of notes of August 7, 1989 on reciprocal exemption of income from the international operation of ships or aircraft shall cease to apply. It was Mexico's preference not to have two outstanding agreements on the same subject matter, and to rely on the treaty provisions once they are in effect.

Article 30. TERMINATION

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of this Article. The Convention may be terminated at any time after 5 years from the date of its entry into force, provided that written notice has been given through diplomatic channels at least six months in advance. If such notice is given, the Convention will cease to apply in respect of taxes withheld on dividends, interest and royalties paid or credited on or after the first day of the second month following the six month period and with respect to other taxes for taxable periods beginning on or after the first of January following the six month period. Thus, for example, if notice of termination is given after June 30 of a given year, the termination will not generally be effective as of the following January 1, since the notice period must last for at least six months.

Point 30 of the Protocol relates to unilateral termination of the Convention by a Contracting State before the expiration of the five year minimum period provided for in paragraph 1 of Article 30. This provision was included at the request of Mexico to address the possibility of future U.S. legislative provisions overriding one or more treaty provisions. If that occurs in either Contracting State, and if the effect is to significantly limit a benefit provided by the Convention, the other State may request consultations with a view to modifying the Convention to restore the balance of benefits. The first State shall accede to such request by beginning consultations within three months of the request. If the States are unable to agree on how to modify the Convention to restore the balance of benefits, the affected State may terminate the Convention in accordance with Article 30 even if it has not been in force for five years.

Neither this provision nor Article 30 prevents the Contracting States from entering into a new bilateral agreement that supersedes, amends, or terminates provisions of the Convention either prior to the expiration of the five year period or without the six month notification period.

PROTOCOL

The provisions of the Protocol are an integral part of the Convention. Each has been described in the discussion of the Article to which it refers.

Revenue Proposals in Health Security Act

1. Increase in Tax on Tobacco Products - The federal excise tax on cigarettes will be increased by $.75 per pack to $.99 per pack, effective October 1, 1994. Comparable increases in federal excise taxes on other tobacco products will also be included. Floor stocks will also be taxed, and other appropriate measures will be included to ensure collection of tax.

2. Assessment on Corporate Alliance Employers - An annual one-percent assessment on total payroll will be levied on firms that provide health insurance through corporate alliances. The assessment will generally be effective beginning January 1, 1996.

3. Effects of Employer Mandate, Cost Containment, and Subsidies on Individual Income and Payroll Taxes - Employers will be required to contribute towards the costs of a comprehensive health insurance plan for their employees. The effects of the mandate will be mitigated by subsidies to employers and reductions in the growth of health insurance costs. In combination, these aspects of the health care reform proposal are anticipated to cause a net increase in taxable wages.

4. Health Insurance -

   a. Increase in Deduction for Health Insurance Costs of Self-Employed Individuals - The individual income tax health insurance deduction for self-employed taxpayers will be increased to 100 percent of the premiums paid to a health alliance for the comprehensive benefit package. A self-employed taxpayer could claim the 100-percent deduction once the taxpayer's State of residence establishes a regional alliance. The current 25-percent health insurance deduction for self-employed taxpayers would be extended until then.

   b. Limitations on Exclusion of Employer-Provided Health Coverage and on Contributions for Health Coverage through Cafeteria Plans - In order to promote cost consciousness on the part of employees, contributions for health benefits through cafeteria plans (or flexible spending arrangements) will no longer be excludable from income as of January 1, 1997. Employer contributions for the comprehensive benefit package (up to 100 percent of the cost of the package) will continue to be excluded from income for purposes of calculating individual income and employment taxes, but, beginning in 2003, employees will include in taxable income and wages employer-paid premiums for supplemental health coverage, including employer-paid co-pays and deductibles.

5. Long-Term Care -

   a. Qualified Long-Term Care Services Treated as Medical Care - Qualified long-term care expenses incurred by certain incapacitated individuals will be treated as

deductible medical expenses (subject to the 7.5-percent of AGI floor). The proposal will be effective for taxable years beginning after December 31, 1995.

b. Treatment of Long-Term Care Insurance

Medical Deduction for Qualified Long-Term Care Insurance Premiums - Qualified long-term care insurance premiums will be deductible as expenses for medical care (subject to the 7.5-percent of AGI floor). The proposal will be effective for taxable years beginning after December 31, 1995.

Exclude Benefits Paid Under Qualified Long-Term Care Policies from Taxable Income - Taxpayers will be able to exclude up to $150 per day from taxable income for benefits paid under qualified long-term care policies. Qualified policies will have to satisfy certain requirements, including benefit eligibility standards. The $150 cap will be indexed for inflation. The proposal will be effective for policies issued after December 31, 1995.

Exclude Value of Employer-Paid Qualified Long-Term Care Coverage - Employers will be able to deduct premiums paid for qualified long-term care coverage. Employees will be able to exclude the value of such employer-paid coverage from income for purposes of calculating individual income and employment taxes. The proposal will be effective for policies issued after December 31, 1995.

c. Tax Treatment of Accelerated Death Benefits - For taxable years beginning after December 31, 1993, distributions to an individual under a life insurance contract on the life of an insured who is terminally ill will be treated as an amount paid by reason of death, and thus be received tax-free. After receipt of a qualifying physician's certification, an insurer can determine that an individual has an illness or physical condition that is terminal and likely to result in death within 12 months.

d. Credit for Cost of Personal Assistance Service Required by Employed Individuals - Impaired taxpayers with earned income will be allowed to take a non-refundable tax credit equal to 50 percent of certain impairment-related personal assistance services (PAS) expenses up to $15,000. The maximum annual tax credit will be the lesser of 50 percent of the taxpayer's earned income or $7,500 (50 percent of $15,000). The PAS expenses covered under this proposal would include only expenses made by taxpayers who need help with activities of daily living. Taxpayers who take the tax credit for a particular PAS expense will not be allowed to take an itemized deduction for the same expense. This credit will be reduced for taxpayers with adjusted gross income between $50,000 and $70,000. Taxpayers with adjusted gross income in excess of $70,000 will not be eligible for the credit. The proposal will be effective for expenses incurred after December 31, 1995.

6. Tax Incentives for Health Service Providers in Shortage Areas -

a. Tax Credit for Primary Health Services Providers in Health Professional Shortage Areas - A physician who works full-time in an area that is designated as being short of health professionals and who receives the required certification from HHS will be eligible to receive a nonrefundable tax credit of $1,000 per month for up to 60 months. Physicians must work in the area for five consecutive years to receive the full credit; physicians will receive a portion of the credit if they work more than two consecutive years in the area. Certified nurse-midwives, nurse practitioners, and physician assistants who work in health professional shortage areas can receive a nonrefundable tax credit of $500 per month for up to 60 months, subject to the same restrictions as physicians. The proposal will be effective for taxable years beginning after December 31, 1994.

b. Expensing for Medical Equipment in Health Professional Shortage Areas - For physicians who work in areas designated as being short of health professionals, the section 179 expensing limit will be increased by $10,000 for medical equipment. The proposal will be effective for equipment placed in service after December 31, 1994.

7. Compliance -

a. Modification to Self-Employment Tax Treatment of Certain S Corporation Shareholders and Partners - To prevent avoidance of health care premium payment responsibilities and self-employment taxes, shareholders who own two percent or more of the stock in a service industry Subchapter S corporation will be required to pay self-employment Social Security tax on their non-wage income from the Subchapter S corporation. Limited partners, if they materially participate, will be taxed in a similar manner. The proposal will be effective for taxable years beginning after December 31, 1995.

b. Employment Status Issues - To prevent employers from avoiding their health care premium payment responsibilities and obtaining inappropriate premium discounts, the Secretary of the Treasury will be given greater authority to prevent in the future mischaracterization of employees as independent contractors. In addition, the penalty for not reporting a payment made to an independent contractor will be increased from $50 to the higher of $50 or five percent of the payment. The proposal will be effective for information returns due more than 30 days after the date of enactment.

8. Retiree Health -

a. Income-Relating of Retiree Health Subsidies - Beginning January 1, 1998, retirees between the ages of 55 and 64 will be eligible for a discount for the employer share of their health insurance premiums. High-income taxpayers will repay the discount. The repayment of the discount will be phased in (over a $10,000 range) for single taxpayers with combined income above $90,000 and married couples filing joint returns with

"combined income" above $115,000. Subject to certain exceptions, combined income is equal to a taxpayer's adjusted gross income (including taxable Social Security benefits) plus tax-exempt interest income. Because the discount repayment will be based on income, it will administered through the individual income tax system. The proposal will be effective for discounts received after December 31, 1997.

b. Early Retiree Health Assessment - A temporary assessment will be levied on employers who provided health insurance benefits to their retired workers between the ages of 55 and 64 ("early retirees"). Beginning in 1998, the assessment will be levied for three years. In each of these three years, employers will pay 50 percent of the greater of (1) the amount that firms would have paid for covering their early retirees in the absence of Health Care Reform, and (2) the annual average of the actual early-retiree health benefits paid by the employer during the period 1991-93, adjusted for medical cost inflation. The assessment will apply to both private and government employers.

c. Post-Retirement Medical and Life Insurance Reserves and Retiree Health Accounts Maintained by Pension Plans - In light of the substantial changes proposed with respect to retiree health benefits, and to prevent the use of multiple vehicles to exceed the intended retiree health funding limits, employers will no longer be able to contribute to retiree medical 401(h) accounts in pension plans, generally effective January 1, 1995. Already-contributed funds in 401(h) accounts will be grandfathered, however, and will continue to receive current law tax treatment until withdrawn. Moreover, to curb current abuses, additions to reserves for post-retirement medical or life benefits in funded welfare benefit plans (typically VEBAs), will be determined on a level basis over a period of at least 10 years.

9. Tax Treatment of Health Care Organizations - Blue Cross/Blue Shield organizations currently receive favorable income tax treatment because they provide open enrollment on a community rated basis. Under reform, all plans will be required to meet those standards and, as a result, two differences between the taxation of Blue Cross/Blue Shield organizations and other property/casualty insurance companies will be eliminated. First, Blue Cross/Blue Shield organizations will not be allowed to deduct the difference between 25 percent of their health claims and adjusted surplus. Second, these organizations will be required to include 20 percent of the change in their unearned premium reserves in taxable income. The proposal will generally be effective for taxable years beginning after December 31, 1996. In addition, in order to maintain their tax-exempt status, hospitals and other nonprofit health providers will be required to assess the health needs of their community and develop a plan to meet those needs. The Act also clarifies that, except for "point of service" benefits, most types of insurance provided by health maintenance organizations are not commercial-type insurance, within the meaning of section 501 (m).

Other Items

10. Recapture of Medicare Part B Subsidies - High-income taxpayers who opt to enroll in Medicare Part B will be required to pay additional premiums. The additional premium will increase these taxpayers' total Medicare Part B contribution from about 25 percent of program costs to about 75 percent of program costs. The additional premiums will be phased in (over a $10,000 range) for single filers with "combined income" above $90,000 and joint filers with combined income above $115,000. Subject to certain exceptions, combined income is equal to a taxpayer's adjusted gross income (including taxable Social Security benefits) plus tax-exempt interest income. Because the additional premiums will be based on income, the premiums will be administered through the individual income tax system. The proposal will be effective January 1, 1996.

11. Extend Medicare Hospital Insurance Tax to All State and Local Government Employees - Medicare coverage on a mandatory basis will be extended to all employees of State and local governments not otherwise covered under present law, without regard to their dates of hire. These employees and their employers will become liable for the hospital insurance portion of the FICA tax, and the employees will earn credit toward Medicare eligibility based on their covered earnings. The proposal will be effective on October 1, 1995.

12. Assessment on Premiums in Regional Alliances - Beginning October 1, 1995, a 1.5 percent assessment will be applied to premiums for comprehensive health coverage purchased through regional alliances.

Items That Have Negligible Revenue Effect

13. Limitations on Prepayments of Medical Insurance Premiums - The itemized deduction for medical expenses under Internal Code section 213 would be amended to provide that if a taxpayer pays a premium or other amount for medical care, the benefits of which extend substantially beyond 12 months after the payment, the amount so paid will be treated as paid ratably over the period for which the coverage is provided. This provision would not apply to insurance described in Internal Revenue Code section 213(d)(7), nor to qualified long-term care premiums. The proposal applies to amounts paid for insurance coverage after December 31, 1996.

14. Coordination With COBRA Continuation Coverage Provisions - The requirement that health care continuation coverage (commonly referred to as "COBRA" coverage) be provided under a group health plan will be repealed as of the earlier of January 1, 1998, or the date on which all States have a regional alliance in effect. In the interim prior to repeal, COBRA coverage for employees and beneficiaries will terminate at the time that the employee or beneficiary is eligible to participate in a health care plan through a qualified alliance.

15. Regional Alliances - Regional Alliances will be exempt from federal income tax. This proposal will be effective for taxable years beginning after the date of enactment.

16. Tax-Exempt Bonds for Health Care-Related Entities - Bond proceeds used by a health care alliance or State guaranty fund will be characterized as used in a private business use. Therefore, issues of bonds more than ten percent of the proceeds of which are used to finance the activities of health care alliances or State guaranty funds generally are private activity bonds the interest on which is not tax-exempt.

17. Disclosure of Return Information for Administration of Certain Programs under the Health Security Act - The Internal Revenue Service will be permitted to disclose return information to federal and State agencies for the administration of certain programs providing assistance under the Health Security Act.

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press 202-622-2960
FFB 202-622-2450

For Immediate Release

November 1, 1993

FEDERAL FINANCING BANK

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of September 1993.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $129.3 billion on September 30, 1993, posting an increase of $713.2 million from the level on August 31, 1993. This net change was the result of an increase in holdings of agency debt of $1,692.2 million, and a decrease in holdings of agency-guaranteed loans of $979.0 million. FFB made 18 disbursements, 15 maturity extensions, and 321 repricings in September. FFB also received 46 prepayments in September. September had the largest number of transactions priced in the history of the FFB.

Due to the large number of transactions, the format of the press release has been changed. The new format facilitates automated production of the press release.

During the fiscal year 1993, FFB holdings of obligations issued, sold or guaranteed by other Federal agencies posted a net decrease of $35,093.2 million from the level on September 30, 1992. This net change was the result of a decrease in holdings of agency debt of $27,928.0 million, in holdings of agency assets of $4,398.6 million, and in holdings of agency-guaranteed loans of $2,766.6 million.

Attached to this release are tables presenting FFB September loan activity and FFB holdings as of September 30, 1993.

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
AGENCY DEBT				
RESOLUTION TRUST CORPORATION				
Note 19 /Advance #2	9/20	$2,600,000,000.00	10/1/93	3.137% S/A
GOVERNMENT - GUARANTEED LOANS				
GENERAL SERVICES ADMINISTRATION				
Oakland Office Building	9/3	$176,901,777.75	9/5/23	5.881% S/A
Foley Square Courthouse	9/14	$11,756,626.00	12/11/95	4.043% S/A
ICTC Building	9/16	$5,630,113.03	11/15/93	3.149% S/A
HCFA Headquarters	9/20	$4,183,353.00	6/30/95	3.939% S/A
Chamblee Office Building	9/21	$119,676.24	4/1/97	4.545% S/A
Foley Services Contract	9/21	$429,180.35	12/11/95	4.143% S/A
Memphis IRS Service Cent.	9/21	$159,611.44	1/3/95	3.686% S/A
Oakland Office Building	9/30	$3,462,642.00	9/5/23	5.833% S/A
RURAL ELECTRIFICATION ADMINISTRATION				
Guam Telephone Auth. #371	9/1	$5,600,000.00	12/31/14	5.643% Qtr.
Head Laker Electric #372	9/7	$256,000.00	12/31/26	5.819% Qtr.
Troup Electric #364	9/7	$1,029,000.00	12/31/25	5.798% Qtr.
Allegheny Electric #255	9/8	$4,417,000.00	12/31/19	5.568% Qtr.
Guam Telephone Auth. #371	9/21	$709,000.00	12/31/14	5.621% Qtr.
S. Maryland Elec. #352	9/22	$1,345,000.00	12/31/25	5.982% Qtr.
Randolph Electric #359	9/27	$1,000,000.00	12/31/25	5.772% Qtr.
Head Laker Electric #372	9/28	$50,000.00	12/31/26	5.832% Qtr.
W. Michigan Electric #355	9/28	$551,000.00	12/31/25	5.811% Qtr.
@Alabama Electric #026	9/30	$3,747,494.42	1/3/11	5.418% Qtr.
@Alabama Electric #026	9/30	$4,425,920.03	1/3/11	5.418% Qtr.
@Alabama Electric #026	9/30	$3,607,680.57	1/3/11	5.418% Qtr.
@Alabama Electric #026	9/30	$8,435,856.70	1/3/11	5.418% Qtr.
@Alabama Electric #026	9/30	$9,239,753.06	1/3/11	5.418% Qtr.
@Alabama Electric #026	9/30	$13,864,365.06	1/3/12	5.452% Qtr.
@Alabama Electric #026	9/30	$11,383,402.60	1/3/11	5.418% Qtr.
@Alabama Electric #026	9/30	$9,455,811.61	1/3/11	5.418% Qtr.
@Alabama Electric #026	9/30	$10,352,380.70	1/3/12	5.452% Qtr.

S/A is a Semi-annual rate: Qtr. is a Quarterly rate.
@ interest rate buydown
* maturity extension

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
@Alabama Electric #026	9/30	$11,111,641.52	1/3/12	5.452% Qtr.
@Alabama Electric #026	9/30	$20,985,309.16	1/3/12	5.452% Qtr.
@Alabama Electric #026	9/30	$17,835,115.75	1/3/12	5.452% Qtr.
@Alabama Electric #026	9/30	$7,144,538.56	12/31/14	5.546% Qtr.
@Alabama Electric #026	9/30	$8,950,279.50	12/31/14	5.546% Qtr.
@Alabama Electric #026	9/30	$2,977,551.16	12/31/14	5.546% Qtr.
*Allegheny Electric #093	9/30	$424,721.68	12/31/13	5.516% Qtr.
*Allegheny Electric #093	9/30	$2,973,052.10	12/31/13	5.516% Qtr.
*Allegheny Electric #093	9/30	$2,007,391.26	12/31/13	5.516% Qtr.
*Allegheny Electric #093	9/30	$1,905,965.38	12/31/13	5.516% Qtr.
*Allegheny Electric #175	9/30	$8,639,052.75	12/31/15	5.575% Qtr.
*Allegheny Electric #255	9/30	$3,796,064.20	3/31/94	3.263% Qtr.
*Allegheny Electric #255	9/30	$1,382,117.61	3/31/94	3.263% Qtr.
*Allegheny Electric #255	9/30	$1,949,361.68	3/31/94	3.263% Qtr.
@Associated Electric #132	9/30	$18,200,220.72	12/31/14	5.546% Qtr.
@Associated Electric #132	9/30	$11,770,539.67	12/31/14	5.546% Qtr.
@Associated Electric #132	9/30	$29,190,938.87	12/31/14	5.546% Qtr.
@Associated Electric #132	9/30	$14,714,454.81	12/31/14	5.546% Qtr.
@Central Iowa Power #051	9/30	$4,304,338.50	1/3/11	5.418% Qtr.
@Central Iowa Power #051	9/30	$1,332,999.63	1/3/11	5.418% Qtr.
@Central Iowa Power #051	9/30	$1,088,114.67	1/3/11	5.418% Qtr.
@Central Iowa Power #051	9/30	$1,047,452.96	1/3/11	5.418% Qtr.
@Central Iowa Power #051	9/30	$608,480.81	1/3/11	5.418% Qtr.
@Central Iowa Power #051	9/30	$1,288,820.04	1/3/12	5.452% Qtr.
@Central Iowa Power #051	9/30	$630,871.78	1/3/12	5.452% Qtr.
@Central Iowa Power #051	9/30	$1,324,107.27	1/3/12	5.452% Qtr.
@Central Iowa Power #051	9/30	$2,183,233.68	1/3/12	5.452% Qtr.
@Central Iowa Power #051	9/30	$1,303,995.04	1/3/12	5.452% Qtr.
@Central Iowa Power #051	9/30	$642,003.56	1/3/12	5.452% Qtr.
@Central Iowa Power #051	9/30	$689,925.74	12/31/12	5.484% Qtr.
@Central Iowa Power #051	9/30	$1,279,301.66	12/31/12	5.484% Qtr.
@Central Iowa Power #051	9/30	$647,232.24	12/31/12	5.484% Qtr.
@Central Iowa Power #051	9/30	$836,628.41	12/31/12	5.484% Qtr.
@Central Iowa Power #051	9/30	$466,497.09	12/31/12	5.484% Qtr.
@Central Iowa Power #051	9/30	$758,293.88	12/31/13	5.516% Qtr.

S/A is a Semi-annual rate: Qtr. is a Quarterly rate.
interest rate buydown
maturity extension

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
@Central Iowa Power #051	9/30	$886,129.70	12/31/14	5.546% Qtr.
@Central Iowa Power #051	9/30	$615,327.79	12/31/14	5.546% Qtr.
@Central Iowa Power #051	9/30	$550,101.05	12/31/14	5.546% Qtr.
@Cornbelt Power #055	9/30	$5,246,487.46	1/3/12	5.452% Qtr.
@Cornbelt Power #055	9/30	$1,366,642.91	1/3/12	5.452% Qtr.
@Cornbelt Power #094	9/30	$278,942.71	12/31/14	5.546% Qtr.
@Coop. Power Assoc. #001	9/30	$1,041,038.26	12/31/09	5.382% Qtr.
@Coop. Power Assoc. #001	9/30	$1,652,325.99	12/31/09	5.382% Qtr.
@Coop. Power Assoc. #001	9/30	$3,782,356.81	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$2,942,228.05	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$4,200,577.33	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$5,651,502.38	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$5,052,040.84	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$3,542,665.32	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$5,194,801.96	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$5,891,221.17	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$5,046,056.08	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$5,868,800.03	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$5,879,435.05	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$6,719,826.31	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$5,841,956.56	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$6,661,146.70	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #001	9/30	$4,252,299.54	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$7,669,295.21	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$4,258,762.05	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$7,688,292.24	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$5,120,444.36	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$7,704,573.78	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$10,266,382.66	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$5,971,248.08	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$12,843,370.14	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$14,582,058.96	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$10,259,545.11	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$7,736,556.32	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$17,229,955.68	1/3/12	5.452% Qtr.

S/A is a Semi-annual rate: Qtr. is a Quarterly rate.
@ interest rate buydown
* maturity extension

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
@Coop. Power Assoc. #001	9/30	$8,622,549.48	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #001	9/30	$4,889,151.35	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #005	9/30	$4,985,214.35	1/3/11	5.418% Qtr.
@Coop. Power Assoc. #005	9/30	$1,700,920.17	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #005	9/30	$851,752.53	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #005	9/30	$1,712,676.31	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #005	9/30	$1,714,863.90	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #005	9/30	$2,572,218.58	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #005	9/30	$2,583,804.91	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #005	9/30	$3,454,620.38	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #005	9/30	$1,764,629.31	12/31/12	5.484% Qtr.
@Coop. Power Assoc. #005	9/30	$3,545,634.73	12/31/12	5.484% Qtr.
@Coop. Power Assoc. #005	9/30	$2,658,851.87	12/31/12	5.484% Qtr.
@Coop. Power Assoc. #070	9/30	$3,747,399.53	1/3/12	5.452% Qtr.
@Coop. Power Assoc. #070	9/30	$17,596,568.05	12/31/12	5.484% Qtr.
@Coop. Power Assoc. #070	9/30	$9,699,243.92	12/31/12	5.484% Qtr.
@Coop. Power Assoc. #070	9/30	$6,180,928.48	12/31/12	5.484% Qtr.
@Coop. Power Assoc. #070	9/30	$8,820,725.95	12/31/12	5.484% Qtr.
@Coop. Power Assoc. #070	9/30	$7,090,271.57	12/31/12	5.484% Qtr.
*Coop. Power Assoc. #130	9/30	$12,742,272.64	10/2/95	3.937% Qtr.
*Coop. Power Assoc. #130	9/30	$4,008,264.56	10/2/95	3.937% Qtr.
*Coop. Power Assoc. #240	9/30	$6,879,463.59	10/2/95	3.936% Qtr.
@E. Iowa Coop. #061	9/30	$3,827,069.94	1/3/12	5.452% Qtr.
@E. Iowa Coop. #061	9/30	$2,566,209.94	1/3/12	5.452% Qtr.
@E. Iowa Coop. #061	9/30	$430,872.32	1/3/12	5.452% Qtr.
@E. Iowa Coop. #061	9/30	$472,390.92	12/31/12	5.484% Qtr.
@E. Iowa Coop. #061	9/30	$751,613.98	12/31/12	5.484% Qtr.
@E. Iowa Coop. #061	9/30	$1,285,227.55	12/31/12	5.484% Qtr.
@E. Iowa Coop. #061	9/30	$906,878.69	12/31/13	5.516% Qtr.
@E. Iowa Coop. #061	9/30	$702,983.16	12/31/14	5.546% Qtr.
@E. Iowa Coop. #061	9/30	$254,464.80	12/31/14	5.546% Qtr.
@East Kentucky Power #073	9/30	$20,142,068.32	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$2,134,246.12	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$2,486,870.92	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$2,909,245.61	1/3/12	5.452% Qtr.

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@ interest rate buydown
* maturity extension

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
@East Kentucky Power #073	9/30	$7,397,188.55	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$6,355,034.83	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$5,117,410.70	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$5,112,918.14	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$4,339,630.86	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$4,173,429.62	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$3,492,069.28	1/3/12	5.452% Qtr.
@East Kentucky Power #073	9/30	$2,338,529.73	12/31/12	5.484% Qtr.
@East Kentucky Power #073	9/30	$3,628,776.54	12/31/12	5.484% Qtr.
@East Kentucky Power #073	9/30	$5,239,287.03	12/31/12	5.484% Qtr.
@Glacier State Tele. #029	9/30	$1,188,281.28	1/3/11	5.418% Qtr.
@Glacier State Tele. #029	9/30	$945,906.76	1/3/12	5.452% Qtr.
@Glacier State Tele. #029	9/30	$695,817.29	12/31/12	5.484% Qtr.
@Gulf Telephone Co. #050	9/30	$42,312.50	1/3/12	5.452% Qtr.
@Gulf Telephone Co. #050	9/30	$249,195.01	1/3/12	5.452% Qtr.
@Gulf Telephone Co. #050	9/30	$54,618.15	1/3/12	5.452% Qtr.
@Gulf Telephone Co. #050	9/30	$94,368.33	1/3/12	5.452% Qtr.
@Gulf Telephone Co. #050	9/30	$117,117.84	1/3/12	5.452% Qtr.
@Gulf Telephone Co. #050	9/30	$384,576.43	12/31/12	5.484% Qtr.
@Gulf Telephone Co. #050	9/30	$145,673.24	12/31/12	5.484% Qtr.
@Gulf Telephone Co. #050	9/30	$96,983.35	12/31/12	5.484% Qtr.
@Gulf Telephone Co. #050	9/30	$234,498.37	12/31/12	5.484% Qtr.
@Gulf Telephone Co. #050	9/30	$107,728.81	12/31/12	5.484% Qtr.
@Gulf Telephone Co. #050	9/30	$240,556.70	12/31/12	5.484% Qtr.
@Gulf Telephone Co. #050	9/30	$475,135.71	12/31/12	5.484% Qtr.
@Gulf Telephone Co. #050	9/30	$332,463.37	12/31/13	5.516% Qtr.
@Gulf Telephone Co. #050	9/30	$378,285.75	12/31/13	5.516% Qtr.
@Gulf Telephone Co. #050	9/30	$132,601.88	12/31/13	5.516% Qtr.
@Gulf Telephone Co. #050	9/30	$148,313.32	12/31/13	5.516% Qtr.
@Gulf Telephone Co. #050	9/30	$149,081.95	12/31/13	5.516% Qtr.
@Gulf Telephone Co. #050	9/30	$175,663.61	12/31/13	5.516% Qtr.
@Gulf Telephone Co. #050	9/30	$703,873.12	12/31/13	5.516% Qtr.
@Gulf Telephone Co. #050	9/30	$644,467.20	12/31/14	5.546% Qtr.
@Gulf Telephone Co. #050	9/30	$499,630.99	12/31/14	5.546% Qtr.
@Gulf Telephone Co. #050	9/30	$211,240.97	12/31/14	5.546% Qtr.

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@ interest rate buydown
* maturity extension

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
*Kamo Electric #209	9/30	$1,904,418.36	10/2/95	3.936% Qtr.
*Kamo Electric #266	9/30	$1,337,243.70	10/2/95	3.936% Qtr.
*Kamo Electric #266	9/30	$844,378.30	10/2/95	3.936% Qtr.
*Kamo Electric #266	9/30	$2,631,857.10	10/2/95	3.936% Qtr.
@M & A Electric #111	9/30	$189,244.98	12/31/14	5.546% Qtr.
@Medina Electric #113	9/30	$671,898.00	12/31/13	5.516% Qtr.
@Medina Electric #113	9/30	$679,929.41	12/31/13	5.516% Qtr.
@Northwest Telephone #062	9/30	$154,019.78	1/3/11	5.418% Qtr.
@Northwest Telephone #062	9/30	$1,283,198.57	1/3/12	5.452% Qtr.
@Northwest Telephone #062	9/30	$2,240,601.32	1/3/12	5.452% Qtr.
@Northwest Telephone #062	9/30	$1,698,741.84	1/3/12	5.452% Qtr.
@Northwest Telephone #062	9/30	$311,857.24	12/31/12	5.484% Qtr.
@South Miss. Elec. #003	9/30	$2,978,386.68	12/31/09	5.382% Qtr.
@South Miss. Elec. #003	9/30	$7,487,671.53	12/31/09	5.382% Qtr.
@South Miss. Elec. #003	9/30	$5,454,008.38	1/3/11	5.418% Qtr.
@South Miss. Elec. #003	9/30	$3,736,653.32	1/3/11	5.418% Qtr.
@South Miss. Elec. #003	9/30	$4,643,609.79	1/3/11	5.418% Qtr.
@South Miss. Elec. #003	9/30	$5,768,691.77	1/3/11	5.418% Qtr.
@South Miss. Elec. #003	9/30	$10,566,505.12	1/3/11	5.418% Qtr.
@South Miss. Elec. #003	9/30	$5,627,187.38	1/3/11	5.418% Qtr.
@South Miss. Elec. #003	9/30	$463,239.62	12/31/12	5.484% Qtr.
@South Miss. Elec. #003	9/30	$213,595.13	12/31/13	5.516% Qtr.
@South Miss. Elec. #003	9/30	$294,316.05	12/31/13	5.516% Qtr.
@South Miss. Elec. #003	9/30	$1,750,362.31	12/31/13	5.516% Qtr.
@South Miss. Elec. #003	9/30	$365,720.66	12/31/13	5.516% Qtr.
@South Miss. Elec. #003	9/30	$472,535.66	12/31/13	5.516% Qtr.
@South Miss. Elec. #003	9/30	$1,033,254.71	12/31/13	5.516% Qtr.
@South Miss. Elec. #090	9/30	$226,105.08	12/31/12	5.484% Qtr.
@South Miss. Elec. #090	9/30	$633,338.59	12/31/13	5.516% Qtr.
@South Miss. Elec. #090	9/30	$477,034.04	12/31/13	5.516% Qtr.
@South Miss. Elec. #090	9/30	$1,109,259.35	12/31/13	5.516% Qtr.
@South Miss. Elec. #090	9/30	$604,622.28	12/31/13	5.516% Qtr.
@South Miss. Elec. #090	9/30	$908,181.54	12/31/13	5.516% Qtr.
@South Texas Electric #109	9/30	$1,889,095.37	12/31/14	5.546% Qtr.
@South Texas Electric #109	9/30	$1,855,768.97	12/31/14	5.546% Qtr.

S/A is a Semi-annual rate: Qtr. is a Quarterly rate.
@ interest rate buydown
* maturity extension

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
@South Texas Electric #109	9/30	$578,722.00	12/31/14	5.546% Qtr.
@South Texas Electric #109	9/30	$962,525.27	12/31/14	5.546% Qtr.
@San Miguel Electric #110	9/30	$8,185,284.51	12/31/14	5.546% Qtr.
@San Miguel Electric #110	9/30	$7,269,964.55	12/31/14	5.546% Qtr.
@San Miguel Electric #110	9/30	$7,045,668.65	12/31/14	5.546% Qtr.
@Seminole Electric #052	9/30	$44,560.68	1/3/11	5.418% Qtr.
@Seminole Electric #052	9/30	$47,698.38	1/3/12	5.452% Qtr.
@Seminole Electric #052	9/30	$50,360.60	1/3/12	5.452% Qtr.
@Seminole Electric #052	9/30	$77,017.80	1/3/12	5.452% Qtr.
@Seminole Electric #141	9/30	$11,640,930.84	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$3,994,602.44	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$2,403,158.66	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$2,468,970.31	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$1,173,676.35	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$2,454,448.95	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$1,858,437.17	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$2,014,933.26	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$834,161.28	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$1,922,884.66	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$5,111,444.04	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$2,323,865.63	12/31/14	5.546% Qtr.
@Seminole Electric #141	9/30	$4,188,375.00	12/31/14	5.546% Qtr.
@Sho-Me Power #114	9/30	$255,832.82	12/31/14	5.546% Qtr.
@S. Illinois Power #038	9/30	$376,379.81	12/31/14	5.546% Qtr.
@S. Illinois Power #038	9/30	$696,177.66	12/31/14	5.546% Qtr.
@S. Illinois Power #038	9/30	$474,494.32	12/31/14	5.546% Qtr.
@Tri-State #009	9/30	$3,759,179.64	1/3/11	5.418% Qtr.
@Tri-State #009	9/30	$1,809,053.69	1/3/11	5.418% Qtr.
@Tri-State #009	9/30	$3,514,651.06	1/3/11	5.418% Qtr.
@Tri-State #009	9/30	$3,893,155.11	1/3/11	5.418% Qtr.
@Tri-State #009	9/30	$3,806,168.12	1/3/12	5.452% Qtr.
@Tri-State #009	9/30	$2,781,755.59	1/3/12	5.452% Qtr.
@Tri-State #009	9/30	$4,153,833.46	1/3/12	5.452% Qtr.
@Tri-State #009	9/30	$2,249,482.76	1/3/12	5.452% Qtr.
@Tri-State #009	9/30	$3,076,600.41	1/3/12	5.452% Qtr.

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@ interest rate buydown
* maturity extension

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
@Tri-State #009	9/30	$2,162,013.51	1/3/12	5.452% Qtr.
@Tri-State #009	9/30	$2,672,398.41	1/3/12	5.452% Qtr.
@Tri-State #009	9/30	$5,568,476.32	1/3/12	5.452% Qtr.
@Tri-State #009	9/30	$847,488.12	1/3/12	5.452% Qtr.
@Tri-State #037	9/30	$150,221.68	1/3/11	5.418% Qtr.
@Tri-State #037	9/30	$198,512.41	1/3/12	5.452% Qtr.
@Tri-State #037	9/30	$237,182.74	1/3/12	5.452% Qtr.
@Tri-State #037	9/30	$15,010.68	12/31/14	5.546% Qtr.
@Tri-State #037	9/30	$120,880.78	12/31/14	5.546% Qtr.
@Tri-State #037	9/30	$67,547.95	12/31/14	5.546% Qtr.
@Tri-State #037	9/30	$13,160.46	12/31/14	5.546% Qtr.
@Tri-State #037	9/30	$10,340.30	12/31/14	5.546% Qtr.
@Tri-State #037	9/30	$22,599.72	12/31/14	5.546% Qtr.
@Tri-State #037	9/30	$16,008.14	12/31/14	5.546% Qtr.
@Tri-State #075	9/30	$8,732,417.33	1/3/12	5.452% Qtr.
@Tri-State #075	9/30	$2,813,479.25	1/3/12	5.452% Qtr.
@Tri-State #075	9/30	$1,322,895.31	1/3/12	5.452% Qtr.
@Tri-State #075	9/30	$619,847.47	1/3/12	5.452% Qtr.
@Tri-State #075	9/30	$378,957.77	1/3/12	5.452% Qtr.
@Tri-State #075	9/30	$258,728.86	1/3/12	5.452% Qtr.
@Tri-State #079	9/30	$3,882,596.95	1/3/12	5.452% Qtr.
@Tri-State #079	9/30	$2,141,545.97	1/3/12	5.452% Qtr.
@Tri-State #079	9/30	$3,530,122.97	1/3/12	5.452% Qtr.
@Tri-State #079	9/30	$1,296,655.27	12/31/14	5.546% Qtr.
@Tri-State #079	9/30	$6,636,765.36	12/31/14	5.546% Qtr.
@Tri-State #079	9/30	$384,775.74	12/31/14	5.546% Qtr.
@Tri-State #079	9/30	$397,790.86	12/31/14	5.546% Qtr.
@Tri-State #089	9/30	$4,086,342.97	12/31/14	5.546% Qtr.
@Tri-State #089	9/30	$7,352,017.46	12/31/14	5.546% Qtr.
@United Power Assoc. #002	9/30	$989,566.37	12/31/09	5.382% Qtr.
@United Power Assoc. #002	9/30	$2,403,989.26	12/31/09	5.382% Qtr.
@United Power Assoc. #002	9/30	$3,713,493.94	12/31/09	5.382% Qtr.
@United Power Assoc. #002	9/30	$2,900,683.98	12/31/09	5.382% Qtr.
@United Power Assoc. #002	9/30	$2,796,712.14	12/31/09	5.382% Qtr.
@United Power Assoc. #002	9/30	$2,936,923.69	1/3/11	5.418% Qtr.

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@ interest rate buydown
* maturity extension

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
@United Power Assoc. #002	9/30	$2,933,553.15	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$2,512,379.91	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$4,222,447.84	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$2,946,468.23	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$4,217,459.00	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$1,684,941.48	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$5,889,698.62	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$2,937,335.02	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$5,879,435.05	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$7,559,804.66	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$9,158,406.08	1/3/11	5.418% Qtr.
@United Power Assoc. #002	9/30	$5,068,405.51	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$2,982,503.99	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$4,261,371.45	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$3,414,363.07	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$6,826,218.26	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$8,560,637.67	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$6,842,343.92	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$8,554,754.75	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$11,170,616.67	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$12,500,148.01	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$4,308,458.66	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$8,875,969.80	1/3/12	5.452% Qtr.
@United Power Assoc. #002	9/30	$2,521,511.46	12/31/12	5.484% Qtr.
@United Power Assoc. #006	9/30	$5,099,936.50	1/3/12	5.452% Qtr.
@United Power Assoc. #006	9/30	$1,280,386.13	1/3/12	5.452% Qtr.
@United Power Assoc. #006	9/30	$856,063.89	1/3/12	5.452% Qtr.
@United Power Assoc. #006	9/30	$513,285.32	1/3/12	5.452% Qtr.
@United Power Assoc. #006	9/30	$2,155,198.12	1/3/12	5.452% Qtr.
@United Power Assoc. #006	9/30	$1,464,965.83	1/3/12	5.452% Qtr.
@United Power Assoc. #006	9/30	$879,187.84	12/31/12	5.484% Qtr.
@United Power Assoc. #006	9/30	$2,648,391.25	12/31/12	5.484% Qtr.
@United Power Assoc. #006	9/30	$443,134.09	12/31/12	5.484% Qtr.
@United Power Assoc. #006	9/30	$2,218,196.84	12/31/12	5.484% Qtr.
@United Power Assoc. #006	9/30	$1,161,208.03	12/31/12	5.484% Qtr.

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@ interest rate buydown
* maturity extension

FEDERAL FINANCING BANK
SEPTEMBER 1993 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE
GOVERNMENT - GUARANTEED LOANS				
RURAL ELECTRIFICATION ADMINISTRATION				
@United Power Assoc. #006	9/30	$2,696,527.03	12/31/12	5.484% Qtr.
@United Power Assoc. #006	9/30	$2,688,556.30	12/31/12	5.484% Qtr.
@United Power Assoc. #006	9/30	$2,728,221.80	12/31/13	5.516% Qtr.
@United Power Assoc. #006	9/30	$911,738.55	12/31/13	5.516% Qtr.
@United Power Assoc. #067	9/30	$4,511,992.94	12/31/12	5.484% Qtr.
@United Power Assoc. #067	9/30	$9,702,799.05	12/31/12	5.484% Qtr.
@United Power Assoc. #067	9/30	$7,945,174.23	12/31/12	5.484% Qtr.
@United Power Assoc. #067	9/30	$6,203,878.34	12/31/12	5.484% Qtr.
@United Power Assoc. #067	9/30	$5,944,767.76	12/31/12	5.484% Qtr.
@United Power Assoc. #067	9/30	$9,335,173.87	12/31/12	5.484% Qtr.
@United Power Assoc. #067	9/30	$10,182,901.55	12/31/12	5.484% Qtr.
@United Power Assoc. #067	9/30	$4,044,790.33	12/31/12	5.484% Qtr.
@United Power Assoc. #067	9/30	$15,432,630.11	12/31/13	5.516% Qtr.
@United Power Assoc. #067	9/30	$5,188,852.35	12/31/13	5.516% Qtr.
@United Power Assoc. #067	9/30	$188,751.15	12/31/14	5.546% Qtr.
@United Power Assoc. #067	9/30	$1,422,874.48	12/31/14	5.546% Qtr.
@United Power Assoc. #086	9/30	$1,067,559.93	12/31/12	5.484% Qtr.
@United Power Assoc. #086	9/30	$987,030.27	12/31/12	5.484% Qtr.
@United Power Assoc. #086	9/30	$897,840.18	12/31/12	5.484% Qtr.
@United Power Assoc. #086	9/30	$1,630,980.38	12/31/13	5.516% Qtr.
@United Power Assoc. #086	9/30	$1,003,547.81	12/31/13	5.516% Qtr.
@United Power Assoc. #086	9/30	$552,404.22	12/31/14	5.546% Qtr.
@United Power Assoc. #086	9/30	$2,029,075.84	12/31/14	5.546% Qtr.
@United Power Assoc. #086	9/30	$1,028,577.29	12/31/14	5.546% Qtr.
@United Power Assoc. #086	9/30	$597,581.65	12/31/14	5.546% Qtr.
@United Power Assoc. #129	9/30	$8,776,932.15	12/31/14	5.546% Qtr.
@United Power Assoc. #129	9/30	$4,268,623.76	12/31/14	5.546% Qtr.
@W. Farmer Elec. #022	9/30	$1,188,702.64	1/3/12	5.452% Qtr.
@W. Farmer Elec. #064	9/30	$6,730,925.77	1/3/11	5.418% Qtr.
@W. Farmer Elec. #064	9/30	$17,616,451.95	1/3/11	5.418% Qtr.
@W. Farmer Elec. #064	9/30	$9,248,394.66	1/3/11	5.418% Qtr.
@W. Farmer Elec. #064	9/30	$4,278,760.76	1/3/12	5.452% Qtr.
@W. Farmer Elec. #064	9/30	$3,280,750.77	1/3/12	5.452% Qtr.
@W. Farmer Elec. #064	9/30	$5,560,103.26	12/31/12	5.484% Qtr.
@W. Farmer Elec. #064	9/30	$2,139,598.21	12/31/12	5.484% Qtr.

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@ interest rate buydown
* maturity extension

FEDERAL FINANCING BANK
(in millions)

Program	September 30, 1993	August 31, 1993	Net Change 9/1/93-9/30/93	FY '93 Net Change 10/1/92-9/30/93
Agency Debt:				
Export-Import Bank	$ 5,794.6	$ 6,252.3	$ -457.8	$ -1,897.9
Federal Deposit Insurance Corporation	0.0	0.0	0.0	-10,160.0
Resolution Trust Corporation	31,687.7	29,087.7	2,600.0	-14,848.2
Tennessee Valley Authority	6,325.0	6,325.0	0.0	-850.0
U.S. Postal Service	9,731.5	10,181.5	-450.0	-171.9
sub-total*	53,538.8	51,846.6	1,692.2	-27,928.0
Agency Assets:				
Farmers Home Administration	38,619.0	38,619.0	0.0	-4,360.0
DHHS-Health Maintenance Org.	30.9	30.9	0.0	-24.3
DHHS-Medical Facilities	51.3	51.3	0.0	-13.0
Rural Electrification Admin.-CBO	4,598.9	4,598.9	0.0	0.0
Small Business Administration	2.8	2.9	-0.0	-1.3
sub-total*	43,303.0	43,303.0	-0.0	-4,398.6
Government-Guaranteed Loans:				
DOD-Foreign Military Sales	4,083.4	4,130.8	-47.4	-260.9
DEd.-Student Loan Marketing Assn.	4,790.0	4,790.0	0.0	-30.0
DEPCO-Rhode Island	30.4	30.4	0.0	-94.6
DHUD-Community Dev. Block Grant	131.4	133.5	-2.1	-43.1
DHUD-Public Housing Notes	1,801.0	1,801.0	0.0	-52.3
General Services Administration +	1,585.7	1,563.2	22.5	808.8
DOI-Guam Power Authority	0.0	0.0	0.0	-27.0
DOI-Virgin Islands	22.9	22.9	0.0	-0.9
DON-Ship Lease Financing	1,528.3	1,528.3	0.0	-47.9
Rural Electrification Administration	17,653.3	17,896.7	-243.4	-489.7
SBA-Small Business Investment Cos.	90.4	94.2	-3.8	-53.0
SBA-State/Local Development Cos.	576.4	581.1	-4.7	-57.3
TVA-Seven States Energy Corp.	0.0	700.0	-700.0	-2,416.8
DOT-Section 511	16.9	17.1	-0.1	-2.1
DOT-WMATA	177.0	177.0	0.0	0.0
sub-total*	32,487.0	33,466.0	-979.0	-2,766.6
grand-total*	$129,328.8	$128,615.6	$ 713.2	$-35,093.2

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

MOZELLE W. THOMPSON

Deputy Assistant Secretary (Government Financial Policy)

Mozelle W. Thompson was appointed Deputy Assistant Secretary of the Treasury (Government Financial Policy) on August 27, 1993.

He is responsible for federal intergovernmental lending and oversees the operation of the Federal Financing Bank, the Office of Corporate Finance and the Office of Synthetic Fuels Projects.

Before his appointment to the Treasury Department he held a number of positions with the State of New York going back to 1990. When he left New York State he was senior vice president, counsel and secretary to the boards of the New York State Housing Finance Agency, the State of New York Mortgage Agency, the New York State Medical Care Facilities Finance Agency as well as their related corporations--the New York State Affordable Housing Corporation, the Project Finance Agency and the Municipal Bond Bank Agency.

He was also an adjunct associate professor of law at the Fordham University School of Law. He taught courses in municipal law and finance.

Thompson is a graduate of Columbia College and Columbia Law School, and holds an M.P.A. from Princeton University's Woodrow Wilson School of Public and International Affairs. After graduation he served as law clerk to U.S. Federal Judge William M. Hoeveler in Miami, Florida.

He is active in a number of professional and civic organizations including the Association of Black Princeton Alumni and the Executive Board of Practicing Attorneys for Law Students, a mentoring organization helping African-American and Latino law students. He is a member of the bar in New York State and the District of Columbia.

Thompson was born in Pittsburgh, Pennsylvania on December 11, 1954.

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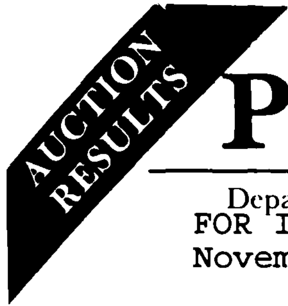


PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
November 1, 1993

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $13,464 million of 13-week bills to be issued November 4, 1993 and to mature February 3, 1994 were accepted today (CUSIP: 912794H72).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	3.09%	3.16%	99.219
High	3.11%	3.18%	99.214
Average	3.11%	3.18%	99.214

Tenders at the high discount rate were allotted 46%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	31,778	31,778
New York	48,262,215	12,336,583
Philadelphia	7,820	7,820
Cleveland	32,214	32,214
Richmond	38,366	38,366
Atlanta	21,938	21,938
Chicago	1,940,103	82,053
St. Louis	7,954	7,954
Minneapolis	16,671	11,271
Kansas City	23,105	23,105
Dallas	16,701	16,701
San Francisco	542,048	42,048
Treasury	812,217	812,217
TOTALS	$51,753,130	$13,464,048
Type		
Competitive	$46,417,379	$8,128,297
Noncompetitive	1,271,136	1,271,136
Subtotal, Public	$47,688,515	$9,399,433
Federal Reserve	2,989,615	2,989,615
Foreign Official Institutions	1,075,000	1,075,000
TOTALS	$51,753,130	$13,464,048

LB-472

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
November 1, 1993

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $13,429 million of 26-week bills to be issued November 4, 1993 and to mature May 5, 1994 were accepted today (CUSIP: 912794K45).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	3.24%	3.34%	98.362
High	3.25%	3.35%	98.357
Average	3.25%	3.35%	98.357

Tenders at the high discount rate were allotted 86%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	21,470	21,470
New York	40,859,770	12,313,950
Philadelphia	4,077	4,077
Cleveland	35,242	35,242
Richmond	24,614	24,614
Atlanta	24,114	23,190
Chicago	2,659,227	88,979
St. Louis	7,610	7,610
Minneapolis	8,185	8,185
Kansas City	16,741	16,741
Dallas	10,871	10,871
San Francisco	561,910	273,410
Treasury	600,383	600,383
TOTALS	$44,834,214	$13,428,722
Type		
Competitive	$40,328,253	$8,922,761
Noncompetitive	950,761	950,761
Subtotal, Public	$41,279,014	$9,873,522
Federal Reserve	2,750,000	2,750,000
Foreign Official Institutions	805,200	805,200
TOTALS	$44,834,214	$13,428,722

LB-473

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

FOR RELEASE AT 3:00 P.M.
November 1, 1993

CONTACT: Michelle Smitl
(202) 622-296(

TREASURY ANNOUNCES MARKET BORROWING ESTIMATES

The Treasury Department on Monday announced its net market borrowing for the October-December 1993 quarter is estimated to be $85.2 billion, with a $35 billion cash balance on December 31. Treasury also announced its net market borrowing for the January-March 1994 quarter is estimated to be in a range of $60 billion to $65 billion, with a $20 billion cash balance at the end of March.

In the quarterly announcement of its borrowing needs on August 2, 1993, Treasury estimated net market borrowing during the October-December 1993 quarter to be in a range of $95 billion to $100 billion, assuming a $35 billion cash balance on December 31.

Actual market borrowing in the quarter ended September 30, 1993, was $44.3 billion while the end-of-quarter cash balance was $52.5 billion. On August 2, Treasury had estimated market borrowing for the July-September quarter to be $58.3 billion, with a $40 billion cash balance on September 30. Larger receipts and lower outlays resulted in the decrease in market borrowing in the July-September quarter and the higher end-of-quarter cash balance.

-30-

LB-474

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
November 1, 1993

Contact: Peter Hollenbach
(202) 219-3302

BUREAU OF THE PUBLIC DEBT AIDS SAVINGS BOND OWNERS AFFECTED BY CALIFORNIA FIRES

The Bureau of the Public Debt took action to assist victims of the fires in southern California by expediting the replacement or payment of United States Savings Bonds for owners in the affected area. The emergency procedures are effective immediately for paying agents and owners in the following California counties: Los Angeles, Orange, Riverside, San Bernadino, San Diego and Ventura. The emergency procedures will remain in effect through December 31, 1993.

Public Debt's action waives the normal six-month minimum holding period for Series EE savings bonds presented to authorized paying agents for redemption by residents of the affected area. Most financial institutions serve as paying agents for savings bonds.

Public Debt will also expedite the replacement of lost or destroyed bonds. Bond owners should complete form PD-1048, available at most financial institutions or the Federal Reserve Bank. Investors should include as much information as possible about the lost bonds on the form. This information should include how the bonds were inscribed, social security number, approximate dates of issue, bond denominations and serial numbers if available. The completed form must be certified by a notary public or an officer of a financial institution. Completed forms should be sent to:

Bureau of the Public Debt
Savings Bond Operations Office
200 Third Street
Parkersburg, WV 26106-1328

Bondowners should write "California Fires" on the front of the envelopes containing claims forms.

oOo

MINUTES OF THE MEETING OF THE TREASURY BORROWING ADVISORY COMMITTEE OF THE PUBLIC SECURITIES ASSOCIATION NOVEMBER 2 AND 3, 1993

November 2

The Committee convened at 9:00 a.m. at the Treasury Department for the portion of the meeting that was open to the public. All members were present, except Mr. Corzine, Mr. Menne, Mr. Pike, and Ms. Recktenwald. The Federal Register announcement of the meeting and a list of Committee members are attached.

Deputy Assistant Secretary for Federal Finance, Darcy Bradbury, welcomed the Committee and the public to the meeting. Assistant Secretary for Economic Policy, Alicia Munnell, gave a brief summary of the current state of the U.S. economy. I gave an informational background briefing updating Treasury borrowing estimates and statistical information on recent Treasury borrowing and market interest rates. The borrowing estimates and background information in chart form had been released to the public on November 1, 1993.

At 10:00 a.m. the Committee met in closed session. Deputy Assistant Secretary Bradbury gave the Committee its "charge", which was to make recommendations on the November Treasury refunding and related matters. See the attached Charge. The Committee also discussed the open-meeting format for informational presentations to the Committee before the Committee meets in closed session to develop its financing recommendations. The partially open meeting format was agreed upon in negotiations between the Treasury and Congress on amendments to the Government Securities Act, which had not been enacted as of the date of the meeting. The Committee also discussed the practical aspects of producing the final report of its recommendations on the third business day after each meeting, instead of after one week, which has been the practice. The meeting adjourned at 10:35 a.m.

The Committee reconvened at 1:35 p.m. in closed session at the Madison Hotel. The meeting began with a discussion of the likely overall Treasury financing need in the rest of the October-December quarter. Specifically, several members believed that the Treasury estimate of $85.2 billion of market borrowing for the quarter is too high. The Committee voted unanimously to recommend that the following issues be sold in the November refunding:

$17.5 billion of 3-year notes, maturing 11-15-96 and

$12.0 billion of 9 3/4-year notes, a reopening of the 5 3/4% notes maturing 8-15-03.

The Committee took the following into consideration in its recommendation to increase the size of the 10-year area note in the November refunding by $1.0 billion to $12.0 billion, compared with the increase of $.25 billion in the August refunding, and specifically to reopen the 5 3/4 percent notes of August 15, 2003:

-- The 10-year note is in demand as an important hedging vehicle for corporate underwriters, mortgage-backed securities market participants, and swap market participants.

-- The 5 3/4 percent notes are in tight supply in the collateral market, as evidenced in special repurchase agreement rates that are well below general collateral rates.

-- The 10-year is the "new long bond" for many accounts, since the Treasury has cut back on issuing new 30-year bonds. A reopening would enhance its trading liquidity.

-- Market conditions in the 10-year maturity area, evidenced by 10-year yields, are favorable for the Treasury as issuer.

-- The elimination of new issues of 7-year notes and the reduction in the frequency of 30-year bond issues to semiannually from quarterly have reduced the tradeable supply of securities in the longer maturity area.

The Committee consensus was that, if the Treasury were to decide to cut back the recommended size of the refunding, it would be preferable to pare the 3-year note.

The Committee then turned to the Treasury's remaining need for cash on November 15 and the financing schedule for the rest of the fourth calendar quarter. The Committee voted unanimously to recommend Treasury cash balances of $35 billion on December 31 and $20 billion on March 31.

The consensus was that the large seasonal swings expected in the Treasury cash balance later this year and early next year call for more frequent issues of cash management bills, with few changes in the size of regular weekly bills. With this in mind, the Committee agreed in principle to the proposed financing schedule that is attached to the Chairman's report. The

Committee also recommended by consensus that the Treasury issue about $14 billion of cash management bills for settlement with the midquarter refunding issues on November 15 and maturing on December 23.

The Committee consensus was that the Treasury estimate of its January-March borrowing requirement, whose midpoint is $62.5 billion, can be accomplished comfortably by increasing the size of the new coupon securities, issuing 30-year bonds, decreasing the size of weekly Treasury bills, and leaving 52-week bills unchanged from the levels recommended for the fourth calendar quarter.

Regarding the calendar, the Committee consensus was that the fact that November 11 is a holiday necessitates auctioning the cash management bills recommended to settle on November 15 on the same day as the auction of one of the regular quarterly refunding issues. The Committee consensus preference was that the 3-year note be auctioned on November 9, with the CMB auction earlier the same day. The recommended calendars are attached to the Chairman's report.

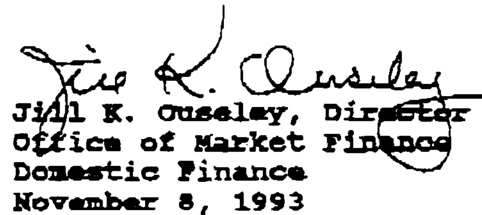
The discussion then turned to the subject of the 6 1/4 percent Treasury bond of August 15, 2023. Committee members expressed the view that evidence of a shortage of the 6 1/4 percent bond for trading in the cash market and in the collateral market raises a potential for a conflict between the reopening policy that the Treasury announced in the Joint Report on the Government Securities Market in January 1992 and the strategy, announced in May 1993, to shorten the maturity mix of new marketable securities offerings.

The meeting adjourned at 3:20 p.m.

November 3

The Committee reconvened at 9:00 a.m. at the Treasury in closed session. All members were present, except Mr. Corzine, Mr. Menne, Mr. Pike, and Ms. Recktenwald. The Chairman presented the Committee report to Under Secretary for Domestic Finance, Frank N. Newman and Deputy Assistant Secretary Bradbury. There was a question-and-answer period related to the recommendations.

The meeting adjourned at 9:30 a.m.



Jill K. Ouseley, Director
Office of Market Finance
Domestic Finance
November 8, 1993

Attachments

Certified by:

Morgan B. Stark, Chairman
Treasury Borrowing Advisory Committee
of the Public Securities Association

1993
TREASURY BORROWING ADVISORY COMMITTEE OF THE PUBLIC SECURITIES ASSOCIATION

CHAIRMAN

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Managing Director
Granite International Capital Group
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New York, NY 10103

VICE CHAIRMAN

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General Manager
Fischer, Francis, Trees & Watts
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London EC2M 7BP England

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Wellington Management Company
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Thomas Bennett
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West Conshohocken, PA 19428

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Chairman of the Board
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New York, NY 10006

Richard B. Roberts
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Winston-Salem, NC 27105

Joseph Rosenberg
President
Lawton General Corporation
667 Madison Avenue
New York, NY 10021-8087

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Managing Director
Morgan Guaranty Trust Co. of NY
60 Wall Street, 20th Fl.
New York, NY 10260

Craig M. Wardlaw
Executive Vice President
NationsBank Corporation
NationsBank Corporate Center
Mail Code NCI 007-0606
Charlotte, NC 28255-0001

ody to be used for any public purpose rith no further obligation to the Federal overnment.

ection 12(k)(2) Determinations

The provision also provides that efore the FTA may authorize such a ansfer for a non-transit use, the FTA iust first determine that:

(A) The asset being transferred will main in public use for not less than 5 ears after the date of the transfer;

(B) There are no purposes eligible for ssistance under the FT Act for which ie asset should be used;

(C) The overall benefit of allowing the ansfer outweighs the Federal overnment interest in liquidation and iturn of the Federal financial interest i the asset, after consideration of fair iarket value and other factors; and

(D) In any case in which the asset is facility or land, there is no interest in cquiring the asset for Federal use.

ederal Interest in Acquiring Land or acility

This document implements the equirements of section 12(k)(2)(D). ccordingly, FTA hereby provides otice of the availability of the land or icility further described below. Any ederal agency interested in acquiring ie affected land or facility should romptly notify the FTA.

If no Federal agency is interested in cquiring the existing land or facility, TA will make certain that the other equirements specified in section 2(k)(2) (A) through (C) are met before ermitting the asset to be transferred.

dditional Description of Land or acility

The property is vacant land, onsisting of two adjacent parcels. 'arcel 49630–1 has an easement with he City of San Jose for an existing nderground sewer line on .077 acres. The unencumbered area of this parcel is 411 acres. Parcel 49641–1 is 2.73 acres of unencumbered property.

Issued on: October 5, 1993.

Portia L. Palmer,

Acting Regional Administrator.

FR Doc. 93–24856 Filed 10–8–93; 8:45 am]

BILLING CODE 4910–57–U

DEPARTMENT OF THE TREASURY

Departmental Offices; Debt Management Advisory Committee; Meeting

Notice is hereby given, pursuant to 5 U.S.C. App. 2 sec. 10(a)(2), that a meeting will be held at the U.S. Treasury Department, 15th and Pennsylvania Avenue NW., Washington, DC, on November 2 and 3, 1993, of the following debt management advisory committee:

Public Securities Association Treasury Borrowing Advisory Committee

The agenda for the meeting provides for a technical background briefing by Treasury staff on November 2, followed by a charge by the Secretary of the Treasury or his designate that the committee discuss particular issues, and a working session. On November 3, the committee will present a written report of its recommendations.

The background briefing by Treasury staff will be held at 9 a.m. Eastern time on November 2 and will be open to the public. The remaining sessions on November 2 and the committee's reporting session on November 3 will be closed to the public pursuant to 5 U.S.C. App. 2 sec. 10(d).

This notice shall constitute my determination, pursuant to the authority placed in heads of departments by 5 U.S.C. App. 2 sec. 10(d) and vested in me by Treasury Department Order No. 101–05, that the closed portions of the meeting are concerned with information that is exempt from disclosure under 5 U.S.C. sec. 552b(c)(9)(A). The public interest requires that such meetings be closed to the public because the Treasury Department requires frank and full advice from representatives of the financial community prior to making its final decision on major financing operations. Historically, this advice has been offered by debt management advisory committees established by the several major segments of the financial community. When so utilized, such a committee is recognized to be an advisory committee under 5 U.S.C. App. 2 sec. 3.

Although the Treasury's final announcement of financing plans may not reflect the recommendations provided in reports of the advisory committee, premature disclosure of the committee's deliberations and reports would be likely to lead to significant financial speculation in the securities market. Thus, these meetings fall within the exemption covered by 5 U.S.C. sec. 552b(c)(9)(A).

The Office of the Under Secretary for Domestic Finance is responsible for maintaining records of debt management advisory committee meetings and for providing annual reports setting forth a summary of committee activities and such other matters as may be informative to the public consistent with the policy of 5 U.S.C. sec 552b.

Dated: October 5, 1993.

Frank N. Newman,

Under Secretary of the Treasury, Domestic Finance.

[FR Doc. 93–24917 Filed 10–8–93; 8:45 am]

BILLING CODE 4810–25–M

Fiscal Service

[Dept. Circ. 750, 1993 Rev., Supp. No. 4]

The Midwestern Indemnity Co.

A Certificate of Authority as an acceptable surety on Federal Bonds is hereby issued to the following company under Sections 9304 and 9308, Title 31, of the United States Code. Federal bond approving officers should annotate their reference copies of the Treasury Circular 570, 1993 Revision on page 35804 to reflect this addition:

The Midwestern Indemnity Company. Business address: 1700 Edison Drive, Milford, OH 45150. Underwriting Limitation b: $6,206,000. Surety Licenses c: AL, GA, IL, IN, IA, KS, MI, MN, MO, NE, NC, OH, PA, TN, VA, WV, WI. Incorporated: Ohio.

Certificates of Authority expire on June 30 each year, unless revoked prior to that date. The Certificates are subject to subsequent annual renewal as long as the companies remain qualified (31 CFR, Part 223). A list of qualified companies is published annually as of July 1 in Treasury Department Circular 570, with details as to underwriting limitations, areas in which licensed to transact surety business and other information.

Copies of the Circular may be obtained form the Department of the Treasury, Financial Management Service, Funds Management Division, Surety Bond Branch, Washington, DC 20227, telephone (202) 874–6850.

Dated: September 30, 1993.

Charles F. Schwan III,

Director, Funds Management Division, Financial Management Service.

[FR Doc. 93–24875 Filed 10–8–93; 8:45 am]

BILLING CODE 4810–35–M

UNITED STATES INFORMATION AGENCY

Performance Review Board Members

AGENCY: United States Information Agency.

ACTION: Notice.

SUMMARY: This Notice is issued to revise the membership of the United States Information Agency (USIA) Performance Review Board.

DATES: Upon publication.

November 2, 1993

COMMITTEE CHARGE

The Treasury would like to have the Committee's specific advice on the following:

Treasury financing

-- the composition of a financing to refund $32.2 billion of privately held notes and bonds maturing on November 15 and to raise new cash in 3- and 10-year notes and cash management bills;

-- whether to reopen the 5-3/4% note of August 15, 2003;

-- the calendar for the refunding auctions;

-- the composition of Treasury marketable financing for the remainder of the October-December quarter and for the January-March quarter; and

-- the appropriate levels of Treasury cash balances on December 31 and March 31.

Other topics

Looking forward, we are also requesting that the Committee recommend the scheduling for the 2- and 5-year note auctions around the holiday periods in November and December.

The Treasury would welcome any comments that the Committee might wish to make on related matters.

REPORT TO THE SECRETARY OF THE TREASURY
FROM THE TREASURY BORROWING ADVISORY COMMITTEE OF THE
PUBLIC SECURITIES ASSOCIATION

November 3, 1993

Dear Mr. Secretary:

Since the Committee's meeting with the Treasury in early August, concerns over the tepid 1.4% growth in GDP during the first half have been replaced by concerns over the confluence of substantial Treasury borrowing in the first fiscal quarter and improved economic vigor, as evidenced by the initial report of third quarter GDP growth which accelerated to 2.8% despite the dampening effects of the mid-west floods. Consensus thinking expects upward revisions and a fourth quarter GDP solidly above 3%, with trend inflation at or below 3%, excepting known tax increases. The recent dramatic drop in oil prices supports the case for a continuing favorable price outlook. Gains in automobile sales and production and in home sales and construction, together with improved borrower creditworthiness and the easing of debt servicing costs, have combined with growth in jobs and income and an increase in consumer confidence and spending to encourage conviction in the current strengthening trend. Future prospects, however, remain constrained by defense cutbacks, soft net exports, continuing corporate downsizing, inventory strategies and de-leveraging.

Over the three-month period, monetary policy remained stable. Treasury yields were unchanged for 2- and 3-year notes, while apart from the anomaly of the current 30-year bond in favor of the old bond, yields for 5-, 7-, and 10-year notes and the 30-year bond were approximately 20 basis points lower, resulting in a general flattening in the yield curve.

It is within this context that the Committee met to consider the composition of the quarterly financing to refund $32.2 billion of privately-held notes and bonds maturing November 15. Given the $85.250 billion financing requirement for the current fiscal quarter and the $36.250 previously issued or announced, there remains a net $49.000 billion to be done. The seventeen Committee members present voted unanimously in favor of a quarter-end balance of $35 billion and for the selling at competitive auction issues in the quarterly refunding totalling $29.500 billion:

-- $17.500 billion of 3-year notes maturing November 15, 1996; and
-- $12.000 billion of the 5 3/4% 9 3/4 year notes.

for a pay down of $2.7 billion. The Committee then voted unanimously in favor of the following summary schedule of borrowing for the remainder of the quarter:

Auctions	Date	Size	Raising
Refunding	November	$29.5 billion	-$ 2.7 billion
2-year Notes	November	$16.5	
	December	$16.5	$ 4.1
5-year Notes	November	$11.0	
	December	$11.0	$22.0
1-year Bills	November	$16.250	
	December	$16.250	$ 3.4
3 & 6 month bills	8 auctions	$27.6	$25.1
Less 7 5/8 12/31/93, four-year note maturity:			-$ 8.2
Net already issued or announced:			$36.250
Plus estimated foreign add-ons:			$ 5.300
Total Net Market Borrowing:			$85.250 billion

Concerning the unanimous vote not only to re-open the existing 10-year (5 3/4% note due 8/15/03) but also to increase its offering size, the Committee cites the following points:

1) The need for the 10-year issue to grow in size to meet prospective borrowing requirements was addressed in our a August 4 report.

2) Evidencing persistent shortages in the collateral markets, the current 10-year issue has been on "special" since its original sale, significantly differing from the pattern that characterized previous 10-year notes.

3) The historically low cost of longer-term borrowing could help offset the risks associated with the current focus on short maturity financing.

4) The cancellation of the 7- and 20-year cycles has significantly reduced previous supply in this sector.

5) Corporate underwriters, mortgage-backed departments and derivative swap desks often use the 7- and 10-year Treasuries for hedging.

6) The marketplace and investing public expect both an increase in the size of the 10-year issue and a re-opening of the outstanding issue.

7) Lastly, a new 10-year note would not likely command a significant liquidity premium. In fact, enlarging the outstanding 10-year should foster its development as the global benchmark issue for the U.S. and thus contribute to the attendant lower yield that a benchmark security typically commands.

As revealed in Treasury's chart presentation and the announcements of the increases in the weekly 3- and 6 month bill auctions to $27.6 billion and of the November 10 auction of $10 billion cash management bills to mature 12/16/93, the Treasury faces a number of intra and inter-quarter cash flow and balance management challenges linked to intra-quarter financing, Treasury cash flows, regular weekly 3- and 6-month bill sizes, concerns about a higher than desirable year-end balance, and the need in December to sell a late January 1994 cash management bill. First, the Committee notes that according to most private forecasts, the Treasury may need as much as $9 billion less in this financing quarter then its forecast indicate. Within the framework of holding 3- and 6-month bills at $27.6 billion for the quarter and the announced $10 billion December 16 cash management settling November 10, the Committee sees the potential need for an intra-quarter $14 billion December 23 cash management bill settling November 15 and a further $10 billion January 27, 1994, cash management bill to settle December 3. Given the usefulness of having a substantial January 27, 1994, maturity when Treasury cash should be high, the Committee recommends reducing the current size of the weekly 3- and 6-month bills sufficiently to accommodate approximately a $10 billion January 27, 1994 cash management bill and bringing the 3- and 6-month bills weekly more in line with the approximately $26.4 billion anticipated levels needed for the second fiscal quarter.

Concerning the follow-on January - March second fiscal quarter, the Committee concurs with the targeted $20 billion quarter-end balance which suggests the following summary of borrowing for the quarter.

Auctions	Size	Raising
Refunding:		
3-year	$17.5	
10-year	12.0	
30-year	11.0	$16.5 billion
2-year Notes	3 x 16.750	5.250
.5-year Notes	3 x 11.250	33.750
1-year Bills	1 x 16.250	
	2 x 16.500	4.800
3- and 6-month Bills	13 x 26.400	10.600

Cash Management Bills	Maturing 1/27	$10	
	New Issue 4/21	$11	1.0
Plus: Estimated foreign add-ons:			6.5
		TOTAL	$78.4 billion

Less:

Maturity of $7.3 billion 7% 1/15/94 7-year Note
and $8.1 billion 8 1/2% 3/31/94 4-year Note

TOTAL	$15.4 billion
Total Net Market Borrowing:	$63.0 billion

Concerning the Treasury's request for the Committee's views on the schedule of auctions for November and December given the holidays, the Committee is pleased to attach its proposed calendar.

Lastly, the Committee discussed at some length the apparent anomaly surrounding the current 30-year bond. The decision of the Treasury announced in May to reduce its reliance on long-term borrowing, shifting to semi-annual 30-year offerings with the aim of borrowing current interest expense, may be seen by the market to conflict with the Treasury's policy of relieving, by means of a reopening, any "acute and protracted shortages" that develops in long-term issues. The Committee continues to support the view that only if all three of the following conditions exist is a reopening warranted:

1) The issue is experiencing lengthy financing pressure with financing costs significantly below general collateral.

2) There exists a known undue concentration of holdings.

3) The issue trades at an excessive price to surrounding issues.

In these circumstances, it would be appropriate to consider reopening the issue in order to retain orderly markets and, most importantly, investor confidence.

In this connection, the Committee notes that the current 30-year is trading some 25 basis points in yield lower than surrounding issues and is being financed to February 15, 1994 at rates well below normal levels. Although the Committee does not believe that

the foregoing criteria for an "acute and protracted shortage" are fully met at present, a situation could possibly develop wherein Treasury's credibility in dealing with such situations might be challenged given the financing strategy announced last May.

Mr. Secretary, this concludes the Committee's report and we stand ready to address your questions and comments.

Morgan B. Stark
Chairman of the Treasury Borrowing
Advisory Committee of the PSA

MBS/kl

Attachments

DRAFT

SCHEDULE OF ISSUES TO BE ANNOUNCED AND AUCTIONED IN NOVEMBER 1993 1/

Monday	Tuesday	Wednesday	Thursday	Friday
1	2	3	4	5 Announce 52 week
8	9 Auction 3 year 2/ CMB (noon)	10 Auction 10 year 2/	11 Holiday	12
15	16 Auction 52 week 3/	17 Announce 2 year 5 year	18	19
22 Auction 2 year 4/ (noon)	23 Auction 5 year 4/	24	25 Holiday	26
29	30			

1/ Does not include weekly bills
2/ For settlement November 15
3/ For settlement November 18
4/ For settlement November 30

Department of the Treasury
Office of Market Finance

November 3, 1993 9

SCHEDULE OF ISSUES TO BE ANNOUNCED AND AUCTIONED IN DECEMBER 1993[1/]

Monday	Tuesday	Wednesday	Thursday	Friday
		1	2	3 Announce 52 week
6	7	8	9 Auction 52 week[2/]	10
13	14	15	16	17
20	21	22 Announce 2 year 5 year	23	24 Holiday
27	28 Auction 2 year[3/]	29 Auction 5 year[3/]	30 Announce 52 week[4/]	31 Holiday

1/ Does not include weekly bills
2/ For settlement December 16
3/ For settlement December 31
4/ For auction January 6 and settlement January 13

Department of the Treasury
Office of Market Finance

November 3, 1993-10

SCHEDULE OF ISSUES TO BE ANNOUNCED AND AUCTIONED IN JANUARY 1994 1/

Monday	Tuesday	Wednesday	Thursday	Friday
3	4	5	6 Auction ~~Announce~~ 52 week 2/	7
10	11	12	13	14
17 Holiday	18	19 Announce 2 year 5 year	20	21
24	25 Auction 2 year 3/	26 Auction 5 year 3/	27	28 Announce 52 week 4/
31				

1/ Does not include weekly bills
2/ For settlement January 16
3/ For settlement January 31
4/ For auction February 3 and settlement February 10

Department of the Treasury
Office of Market Finance

November 3, 1992-11

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

Text as Prepared for Delivery
For Immediate Release
November 3, 1993

STATEMENT OF TREASURY SECRETARY LLOYD BENTSEN BEFORE THE SENATE FINANCE COMMITTEE

As you know, health care reform is an issue which holds great interest for me, and one on which we worked closely with one another over the years when I served here.

Reform of the health care system is one of the President's highest priorities and an integral part of his economic strategy. With the first step, the deficit reduction plan, we have renewed the basis for economic growth and rising wages in America. But deficit reduction by itself will not ensure a higher standard of living for Americans. For too long now, rising health care costs have been a drag on wages and profits. So now we turn to health care reform. From an economic standpoint, failing to act is not an option.

When employers pay their workers more, but health care costs also rise, workers' paychecks don't go up as they should. The average worker today would be earning at least $1,000 more a year if health insurance costs had not risen faster than wages for the last 15 years. Some projections show that if nothing is done, every bit and more of projected wage increases in the coming decade could be consumed by health care costs. Talk about going backwards!

This country spends 14 percent of its GDP on health care -- as much as twice that of some of our major competitors. If nothing is done, health care is projected to consume more than 19 percent of GDP by the year 2000. For all this extra spending, our health is no better than theirs. In many areas, it is worse. We're spending more money and not offering Americans health security.

The President's Health Security plan attacks the fundamental problems of the current system -- the cost, and the tragedy of Americans going without coverage. We are the only major industrialized nation without universal coverage. Nearly 15 percent of our population -- more than 37 million Americans -- have no health coverage. About a third of those are children. Another 22 million more Americans are underinsured.

This lack of universal coverage affects all of us. Every time someone without insurance is treated at an emergency room, each of us with insurance foots the bill. Every time a business leaves its employees without insurance, those with insurance pay the price. Estimates show that corporate premiums are 10 percent higher than they need be in order to pay for uncompensated care.

Universal coverage is critical to getting costs under control. I remember when Lawton Chiles was chairman of the Budget Committee. He was convinced that it was necessary to control health care costs before extending coverage to everyone. Less than a year after becoming governor of Florida, he was back telling this committee he had changed his mind. Universal coverage was absolutely necessary in order to control costs. It is only by solving cost-shifting that you can control costs.

The Health Security plan takes on the coverage issue. It will provide security to all Americans and shift resources to more productive uses. As a result, many businesses will see their costs fall, and others will be able to offer insurance for the first time. Slower cost growth will let workers enjoy real pay raises. Universal coverage will ensure that workers no longer have to fear losing their health insurance if they change jobs or want to start their own business.

We believe the best way to achieve universal coverage is to build on the existing system of insuring individuals at work. Nine out of every 10 Americans with health insurance get it through work. Just as they do today, employers and individuals will pay premiums to cover the bulk of health insurance costs.

The president's plan not only has important benefits for individuals, over the long run it also can lower what business must spend on health insurance. By the end of the decade, preliminary estimates indicate total business spending on the services covered by the health security plan will fall by $10 billion. That savings could be used to hire more workers, to increase wages and benefits, to invest in plants, in equipment, in education or training or research. It also could go for increased dividends or lower prices. Every one of these possibilities can stimulate the economy and create jobs.

And, through the bargaining power of health alliances, it can also level out the playing field for small businesses when it comes to premium rates.

Before I deal with some of the specific revenue issues, there are three general points I want to make.

First, our plan is the only comprehensive proposal that spells out exactly what will be provided and how it will be financed. That is the only fiscally responsible thing to do. During the development of the plan, the administration consulted with the nation's best actuaries and health care experts. I feel confident we have approached the estimating process in a very responsible way.

Second, we have protected both the private sector and the public sector from cost overruns by insisting on accountability.

And third, this plan will be phased in, which allows sufficient time to make adjustments should we find that modifications are needed.

The plan clearly spells out the costs to the federal government and how we are going to pay for them, including discounts to eligible businesses and individuals, long term care and the new Medicare drug benefit. Funding for these, and for program improvements will come largely from slowing the rate of growth in Medicare and Medicaid, a 75-cent increase in the tax on a pack of cigarettes, an assessment on large companies that choose to establish corporate alliances, and increased revenues as compensation shifts from non-taxable health care benefits to taxable wages.

Now, as to some specific revenue items in the bill. You'll find that our proposal contains a number of provisions which have been of interest to the committee over the years.

We propose increasing the excise tax on cigarettes by 75 cents, to 99 cents a pack. We also propose raising the federal excise tax rates on all other tobacco products.

Senators Bradley, Chafee and others on the committee have said for years that increases in tobacco taxes will promote better health -- not just for adults, but very importantly for our children. Like you, I am very concerned about the use of tobacco products by our children.

The health security plan also contains a 1 percent payroll assessment on large employers who opt to form their own health alliances. Among other things, those funds will be used to underwrite important work in health research from which every American benefits.

Another major revenue source in the package is the tax receipts that will result. This accounts for about $23 billion. Let me explain. Increased competition, greater cost-consciousness on the part of both consumers and providers, and other cost containment measures will lower health insurance costs over time. Standard revenue estimating rules assume that as tax-preferred employer health care costs go down, more compensation will be paid in the form of taxable wages. That will generate more income and payroll taxes, despite the increased numbers of workers covered.

There are other tax provisions of the President's plan that will accomplish many of this committee's goals.

For example, we want to help the self-employed better afford their contribution to health coverage. Members of both parties here in the committee have wanted to enact this proposal for years. It's time we get this one done, and we're doing it. We propose that self-employed individuals be able to deduct 100 percent of the cost of the comprehensive benefit package.

In addition, we want to ensure that rural residents, and those who live in the inner cities, have adequate access to quality health care. This plan does that with incentives to encourage doctors and nurses to locate in underserved areas.

The administration has offered a bold and comprehensive plan to give Americans health security and to take charge of health care costs. Next year alone, before we can fully phase in our plan, our health care bill will approach $1 trillion. That's one dollar in every seven in our economy.

The plan we have drafted accomplishes everything many of us tried to do in the last session, and much more. Last year we tried to enact legislation that would have made important but incremental progress in extending health coverage to low-income families. I authored some of those bills because at the time it was as far as I thought we could go in achieving some reform of the health care system.

Things have changed. It has, in fact, been a sea change. Americans know that our health care system needs a comprehensive overhaul. You can see that in every poll in every newspaper you pick up. Americans are very concerned about what's become of our system of health care, and they have a right to be.

It is clear to me that we are going to do something this Congress. You need only look at the legislative landscape to figure that out. There are no fewer than a half dozen plans on the table. There is quite a bit of similarity. For example, all but one call for some form of competition. Every plan wants to get rid of exclusions for pre-existing conditions. Every plan offers a choice of health plans and providers. Each proposes reforms in our malpractice system. And most propose increasing the deduction for self-employed Americans.

We have a significant amount of common ground here. But only the President's plan is truly universal and comprehensive. It provides universal coverage, builds on our existing system of obtaining insurance, contains a Medicare drug benefit, a long term care benefit, cigarette taxes, a requirement that employers help pay for health insurance, and a budget to ensure it is fiscally responsible.

I've been waiting a long time for a president willing to take the lead on this issue. I'm proud to be part of an administration willing to seize this opportunity.

President Clinton is committed to universal coverage and comprehensive benefits, with lifetime coverage, and coverage and cost protections for every American. He is committed to choice in health care. He is intent on seeing that the quality of health care improves. He wants to reduce the paperwork burden for individuals and employers. He wants to make everyone responsible for health care. And, he is intent on financing the Health Security plan in a responsible manner.

The President wants a bipartisan solution to this problem. It is an American issue, not a partisan one. The President looks forward to working with the members of this committee, and others in Congress, to enact a comprehensive and lasting reform of our health care system.

Thank you.

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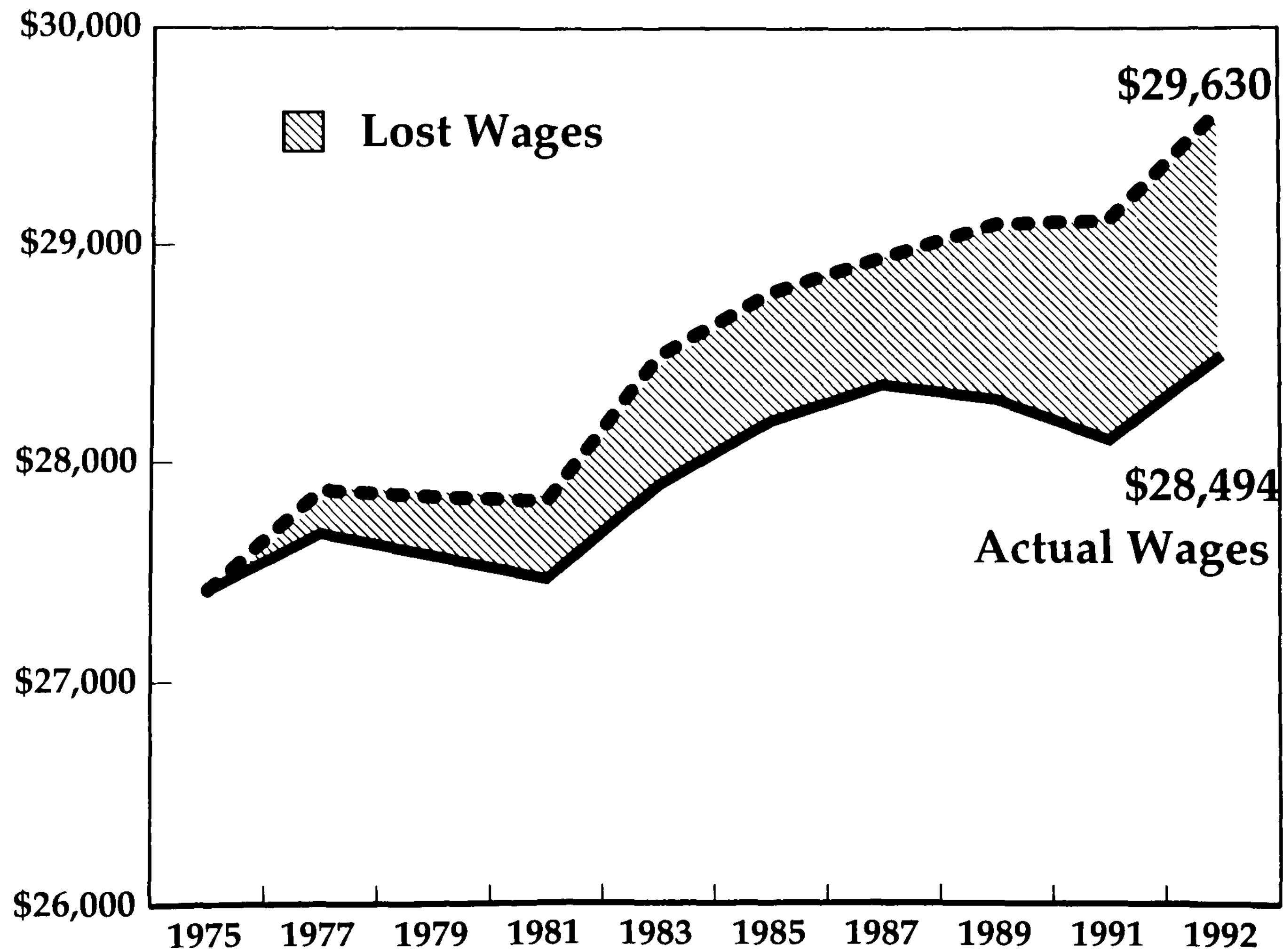
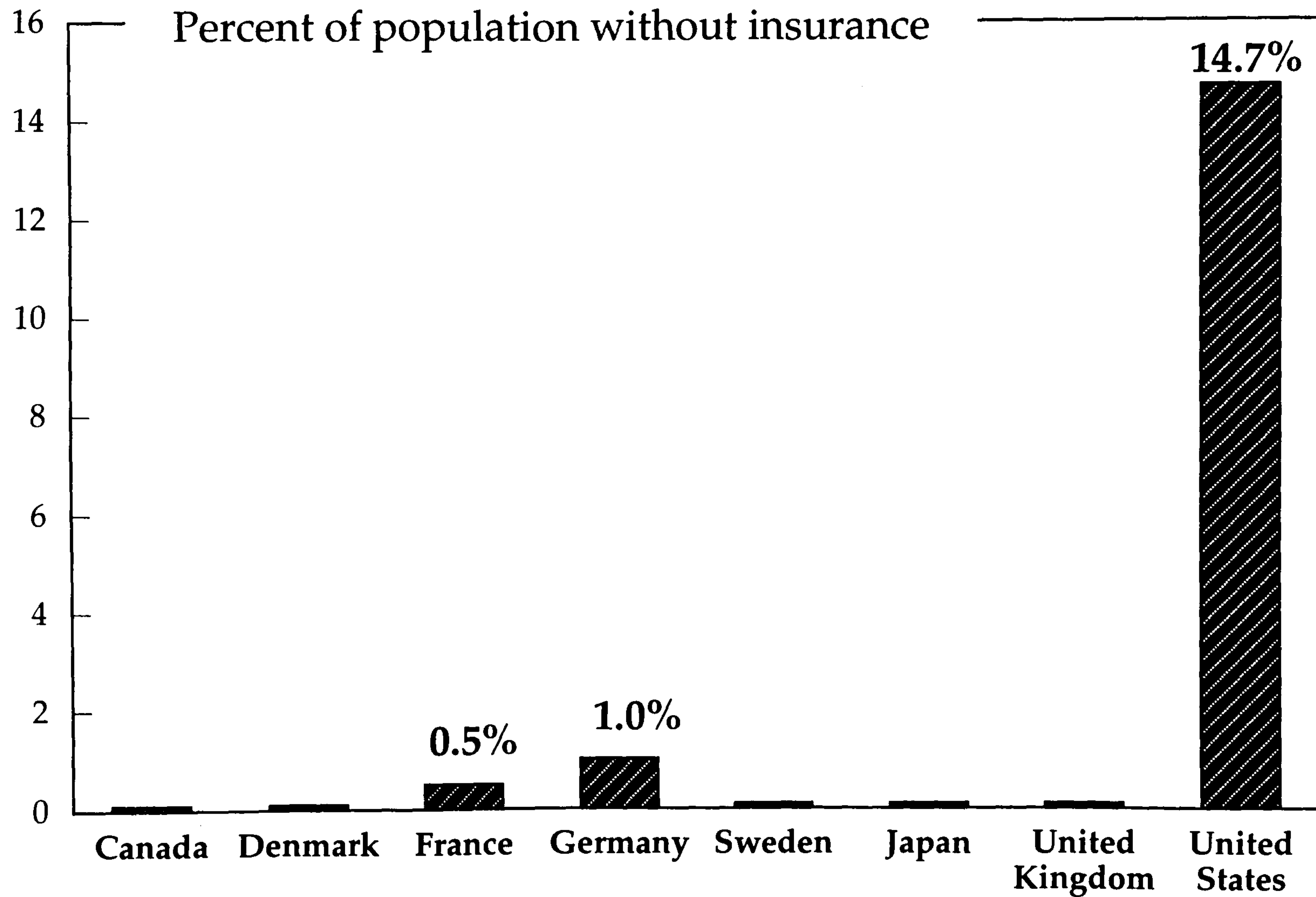
Workers are Losing Wages to Rising Health Costs

:f health care had been reformed in 1975, American workers would have over $1,000 in extra wages every year

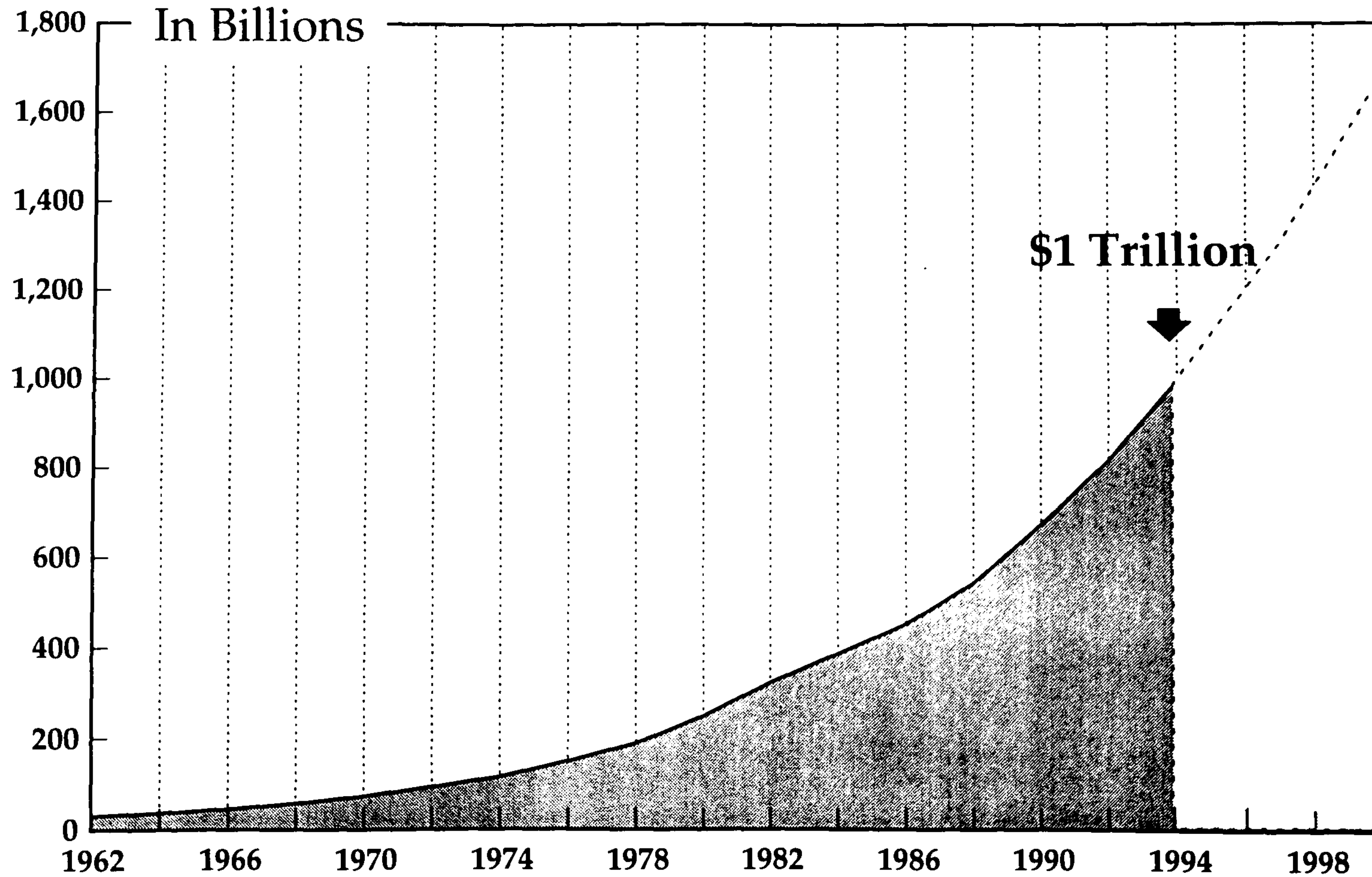




More Americans Lack Health Security
Percent of population without insurance
16
14
12
10
8
6
4
2
0
14.7%
0.5%
1.0%
Canada
Denmark
France
Germany
Sweden
Japan
United Kingdom
United States
Source: Organization of Economic Cooperation and Development

National Health Spending

The U.S. will have a $1 trillion health care bill next year



REVENUE PROPOSALS IN HEALTH SECURITY ACT

Proposal 1/	Effective Date	1994	1995	1996	1997	1998	1999	2000	1994–00
		Fiscal years ($ millions)							
1 Increase in tax on tobacco products	10/1/94	0	12,269	11,107	10,866	10,613	10,348	10,074	65,277
2 Assessment on corporate alliance employers	1/1/96	0	0	3,750	4,940	5,060	5,120	5,210	24,080
3 Health insurance									
a Increase in deduction for health insurance costs of self–employed individuals	1/1/94	–100	–500	–600	–900	–1,700	–2,900	–3,100	–9,800
b Limitations on exclusion of employer–provided health coverage in cafeteria plans	1/1/97 /2	0	0	0	5,000	7,700	8,300	8,900	29,900
4 Long–term care									
a Qualified long–term care services treated as medical care	1/1/96	0	0	–68	–172	–179	–186	–194	–799
b Treatment of long–term care insurance	1/1/96	0	0	–87	–249	–341	–437	–532	–1,646
c Tax treatment of accelerated death benefits	1/1/94	–1	–3	–3	–4	–5	–6	–7	–29
d Credit for cost of personal assistance service required by employed individuals	1/1/96	0	0	–23	–118	–125	–134	–143	–543
5 Tax incentives for health service providers in shortage areas									
a Tax credit for health professionals	1/1/95	0	0	–2	–5	–8	–11	–15	–41
b Expensing for medical equipment	1/1/95	0	–10	–17	–10	–6	–4	–2	–48
6 Compliance									
a Modification to self–employment tax treatment of certain S corporation shareholders and partners	1/1/96	0	0	158	487	509	526	544	2,224
b Modification to penalty for failure to report payments made to independent contractors	30 days after d/o/e	0	53	74	76	80	84	88	455
7 Post–retirement medical and life insurance reserves and retiree health accounts maintained by pension plans	1/1/95	0	21	35	43	51	59	67	276
8 Tax treatment of health care organizations	1/1/97	0	0	0	96	169	186	205	656
TOTAL (REVENUE PROPOSALS):		–101	11,830	14,324	20,050	21,818	20,945	21,095	109,962
Effects of employer mandate, cost containment, and subsidies on income and payroll taxes	10/1/95	0	0	–100	700	3,600	8,000	10,800	23,000

Department of the Treasury
Office of Tax Analysis

November 2, 1993

Notes: 1/ Estimates are not broken out between on–budget and off–budget effects.
2/ Limitations on the exclusion for supplemental health coverage (including employer–paid copays and deductibles) will be effective in 2003.

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

RECORD TESTIMONY OF TREASURY SECRETARY LLOYD BENTSEN
BEFORE THE
SENATE FINANCE COMMITTEE
NOVEMBER 3, 1993

Chairman Moynihan, Senator Packwood. It is a pleasure to have the opportunity to discuss the President's comprehensive health reform plan with you today.

As you know, this is an issue which holds great interest for me, and one on which we worked closely with one another over the years when I was chairman of this committee.

Reform of the health care system is one of the President's highest priorities and an integral part of his economic strategy.

From the beginning, this administration has been dedicated to raising the standard of living in this country for us and for our children. Over the long term the only way to ensure higher standards of living is to have faster real wage growth.

Faster real wage growth requires investment in plant and equipment. But when this administration took office, the country's debt and deficits were growing faster than the economy. This was driving up interest rates and creating a climate that was hostile to business planning and investment.

The first thing we had to do was get our deficit headed down. Our budget plan and its $500 billion in deficit reduction has provided the basis for economic growth and rising wages. As soon as the critical elements of the plan emerged last winter, interest rates began to fall and they have been falling ever since. They're the lowest they've been in 20 years. The interest sensitive sectors of our economy are responding, and we are well on our way to a healthy and steady, investment-led recovery.

Deficit reduction by itself, however, will not ensure higher standards of living. For too long now, rising health care costs have been a drag on wages and profits. So now we turn to health care reform. Let me assure you, from an economic standpoint, failing to act is not an option.

When employers pay their workers more, but health care costs rise also, workers' paychecks don't go up as they should. The average worker today would be earning at least $1,000 more a year if health insurance costs had not risen faster than wages for the last 15 years.

LB-476

Some projections show that if nothing is done, every bit and more of projected wage increases in the coming decade could be consumed by health care costs. Talk about going backwards!

As a nation, we spend 14 percent of GDP on health care. No other developed country spends near that. Japan spends 7 percent and Germany 9 percent. If nothing is done, health care will consume more than 19 percent of GDP by the year 2000.

Maybe spending all this money would be worth it, if we saw good results. But other countries have longer life expectancy and lower rates of infant mortality. They spend less and they cover everyone. We're spending more money and not providing all Americans the security they need.

The Health Security plan addresses the fundamental problems with the current system. The current system costs too much, and the real tragedy is that too many people have inadequate coverage or lack coverage altogether. We are the only major industrialized nation without universal coverage. Nearly 15 percent of our population -- more than 37 million Americans -- have no health coverage. About a third of those are children. Another 22 million Americans are underinsured.

This lack of universal coverage is not a problem just for the uninsured. Every time someone without insurance shows up at the emergency room and is treated, every one of us who has insurance foots the bill. Every time a business leaves its employees without insurance, those with insurance pay the price. Estimates show that many corporate insurance premiums are 10 percent higher than they need be in order to pay for uncompensated care. Removing that burden will end the cost-shifting to businesses and individual policyholders.

Universal coverage is critical to getting costs under control. I remember when Lawton Chiles was chairman of the Budget Committee in the Senate. He was convinced that it was necessary to control health care costs before extending coverage to everyone. Lawton left the Senate and became governor of Florida. Within less than a year he was telling this committee that he had changed his mind. Having universal coverage ends the cost-shifting that hurts our businesses and individuals who have to pay higher premiums for the treatment of those who have no coverage.

The Health Security plan takes on the coverage issue. It will provide security to Americans and shift resources to more productive uses. As a result, some businesses will see their costs fall, and others will be able to offer insurance for the first time. Slower cost growth will allow workers to enjoy faster growth in real wages.

Universal coverage will ensure that workers no longer have to fear losing their health insurance coverage if they change jobs or want to start their own businesses.

To avoid major disruptions, the new system will be financed primarily like the current system. The key to making this plan effective is to build on the system of insuring individuals through their employers. Most businesses, small and large, already cover their workers. Nine of every 10 Americans with private health insurance get it through work. Just as they do today, employer and individual health insurance premiums will pay for the bulk of health coverage.

Employers will be required to pay 80 percent of the average premium. However, the plan limits the percentage of payroll that would be devoted to health care premiums to 7.9 percent for large firms. Small low-wage firms and individuals of modest means would be provided discounts.

The President's plan not only has important benefits for individuals, over the long run it can lower what business must spend on health insurance. By the end of the decade, preliminary estimates indicate total business spending on the services covered by the health security plan will fall by $10 billion. That savings could be used to hire more workers, to increase wages and benefits, to invest in plants, in equipment, in training or education or research. It also could go for increased dividends or lower prices. Every one of these possibilities can stimulate the economy and increase jobs.

And, through the bargaining power of health alliances, it can also level out the playing field for small businesses when it comes to premium rates.

Before I deal with some of the specific revenue issues, there are three general points I want to make.

First, our plan is the only comprehensive proposal that spells out exactly what will be provided and how it will be financed. This is the only fiscally responsible thing to do. During the development of the plan, the administration consulted with the nation's best actuaries and health care experts. I feel confident we have approached the estimating process in a very responsible way.

Second, we have protected both the private sector and the public sector from cost overruns by insisting on accountability.

And third, this plan will be phased in, which allows sufficient time to make adjustments should we find that modifications are needed.

Our plan clearly spells out the costs to the federal government and how we are going to pay for them, including discounts to eligible businesses and individuals, long term care and the new Medicare drug benefit. Funding for these, and for program improvements will come largely from slowing the growth in Medicare and Medicaid, a 75-cent increase in the tax on a pack of cigarettes, an assessment on large companies that choose to establish corporate alliances, and increased revenues as compensation shifts from non-taxable health care benefits to taxable wages.

Now, as to some specific revenue items in the bill. Our proposal contains a number of issues that have been of particular interest to this committee over the years.

As you know, the plan includes a proposal to increase the tax on tobacco products. Specifically, the excise tax on cigarettes would be increased by 75 cents per pack -- raising the federal tax from the current level of 24 cents to just under a dollar a pack. The administration also proposes to increase the federal excise tax rates on all other tobacco products.

As Senators Bradley and Chafee and others on the committee have been saying for years, increases in tobacco taxes will promote better health -- not just among adults, but very importantly among our children. I am particularly concerned about the use of tobacco products by adolescents.

Although we know it will promote better health, I want to elaborate briefly on this point. This is an entirely appropriate way to finance health care for several reasons.

First, tobacco consumption is the leading preventable cause of death and disease in the United States. As members of this committee know, it accounts for about half a million deaths a year and billions of dollars in health care costs.

Second, since the President's health care plan does not generally allow differential health insurance premiums for smokers and non-smokers, the fact of the matter is non-smokers will bear some of the increased health costs of smokers.

Studies by the Department of Health and Human Services, as well as the Canadian experience, demonstrate that raising tobacco taxes can successfully discourage the use of tobacco products by the young. This is particularly true for the proposed increase in taxes on smokeless tobacco. Studies have shown that nearly 20 percent of male high school students use this type of tobacco, and it presently is taxed at a disproportionately low rate in comparison to cigarettes.

The health security plan also contains a 1 percent payroll assessment on large employers who opt to form their own health alliances. That will contribute, among other things, to underwriting important work in health research from which every American benefits.

Another major revenue source in the package is the tax receipts that will result. This accounts for about $23 billion. Let me explain. Increased competition, greater cost-consciousness on the part of both consumers and providers, and other cost containment measures will lower health insurance costs. Standard revenue estimating rules assume that as tax-preferred employer health care costs go down, more worker compensation will come in the form of taxable wages. That will generate more income and payroll taxes, despite the increased number of workers covered.

There are other tax provisions in the President's health plan that will accomplish many of the goals of this committee.

For example, the individual income tax health insurance deductions for self-employed taxpayers will be increased to 100 percent of the costs of the comprehensive benefit package. Members of both parties on this committee have been trying to get that done for years. It's time we got it done. We propose that a self-employed taxpayer could claim the full deduction once the state of residence establishes a regional alliance. The 25 percent health insurance deduction for self-employed workers will continue until the 100 percent deduction is applicable.

In addition, I know that many of you here are very interested in making certain our rural residents, and those who live in the inner cities, have adequate access to quality health care. This plan does that with incentives that encourage doctors and nurses to locate in underserved areas.

We are proposing two tax incentives to encourage adequate medical care in all areas of the country. A physician who works full-time in an area designated as being short of health professionals can receive a tax credit of up to $1,000 per month for up to 60 months. Other health care providers working in these areas can receive a tax credit of up to $500 per month. In addition, physicians who work in these areas will be able to expense an additional $10,000 for medical equipment each year.

There are other ways the tax system will be used to achieve other objectives of the health plan. For example, it will expand and improve long-term care options, stressing home and community-based services and the improvement of the tax rules governing private long-term care insurance.

The plan proposes to modify the current tax treatment of long-term care expenses and insurance. Long-term care expenses incurred by certain incapacitated individuals will be treated as deductible medical expenses, and taxpayers will be able to exclude up to $150 a day from taxable income for benefits paid under qualified long-term care policies. In addition, employers could deduct the premiums paid for these policies, and employees will also be able to exclude the value of this employer-provided coverage from taxable income.

Senators Pryor, Dole, Packwood and I tried to get that done in the last Congress. I am pleased to say that this bill includes that change.

One last point that many on this committee have been discussing for some time. This legislation will base the Medicare Part B premiums on income. Many members have supported this proposal. High-income taxpayers who enroll in part B will see their premiums increased from about 25 percent of program costs to about 75 percent of program costs. The additional premiums will be paid by single taxpayers with income above $90,000, and married couples with income above $115,000. We anticipate this will affect about 2.5 percent of beneficiaries.

CONCLUSION

The administration has offered a bold and comprehensive plan to give Americans health security and take charge of health care costs. Next year alone, before we can fully phase in our plan, our health care bill will exceed $1 trillion. That's one dollar in every seven in our economy.

The plan we have drafted accomplishes everything many of us tried to do in the last session, and much more. You may recall that last year we worked together to fashion several proposals that, taken together, would have made important but incremental progress in extending health coverage to low income families. I helped develop four of those bills because at the time it was as far as I thought we could go in achieving some reform of the health care system.

Things have changed. It has, in fact, been a sea change. Americans recognize that our health care system needs a comprehensive overhaul. You can see that reflected in every poll in every newspaper you pick up. Americans are concerned about what's become of our system of health care, and they have a right to be.

It is clear to me that we are going to do something this term. You need only look at the legislative landscape to figure that out. There are no fewer than half a dozen plans out on the table. There is quite a bit of similarity among them.

For example, all but one call for some form of competition. Every plan wants to get rid of exclusions for pre-existing conditions. Every plan offers a choice of health plans and providers. Each proposes reforms in our malpractice system. And each propose increasing the deduction for self-employed Americans.

We have a significant amount of common ground here. But only the president's plan is truly universal and comprehensive. It provides universal coverage, builds on our existing system of obtaining insurance, contains a Medicare drug benefit, a long term care benefit, cigarette taxes, a requirement that employers help pay for health insurance, and it has a budget to ensure it is fiscally responsible.

I've been waiting a long time for a president willing to take the lead on this issue. The health care problem will cripple our economy if we don't act. I'm proud to be part of an administration willing to seize this opportunity.

President Clinton is committed to universal coverage and comprehensive benefits, with lifetime coverage, and coverage and cost protections for every American. He is committed to choice in health care.

Furthermore, President Clinton is intent on seeing that the quality of health care improves. He wants to reduce the paperwork burden for individuals and employers. He wants to make everyone responsible for health care. And, he is intent on financing the Health Security plan in a responsible manner. This plan does all of that with minimal government intrusion.

The President wants a bipartisan solution to this problem. It is an American issue, not a partisan one. The President looks forward to working with the members of this committee, and others in Congress, to enact a comprehensive and lasting reform of our health care system.

Thank you.

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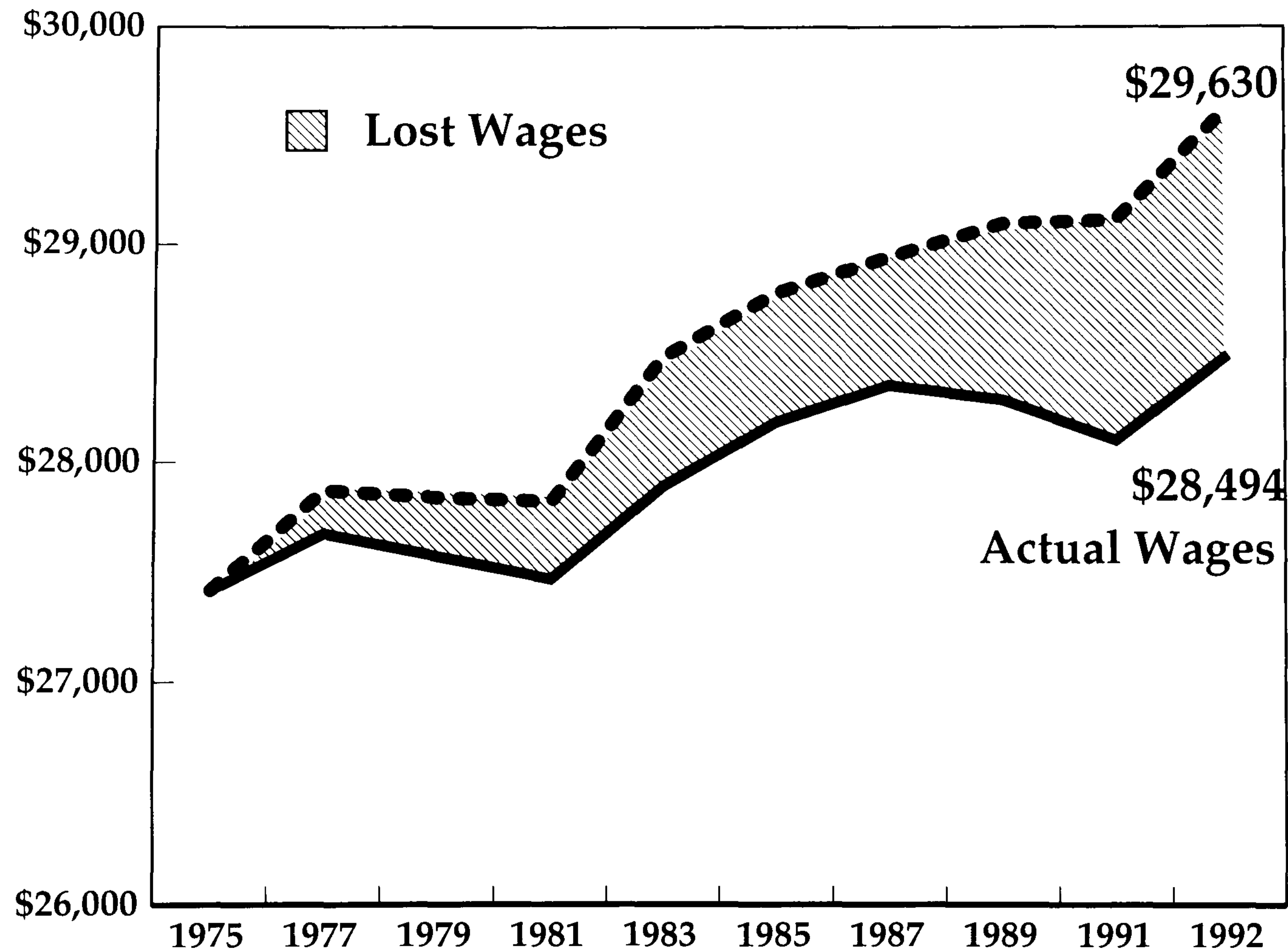
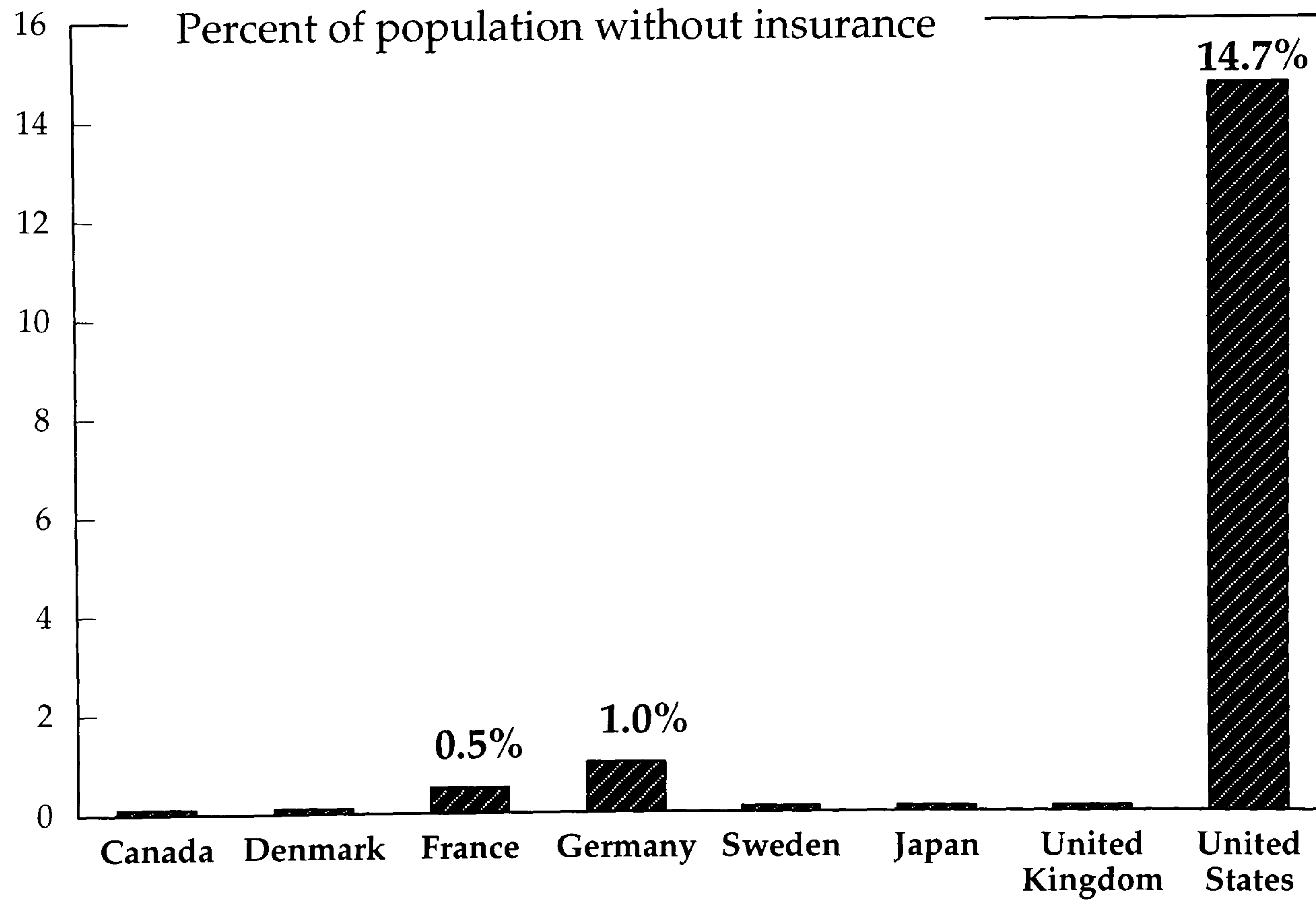
Workers are Losing Wages to Rising Health Costs

If health care had been reformed in 1975, American workers would have over $1,000 in extra wages every year

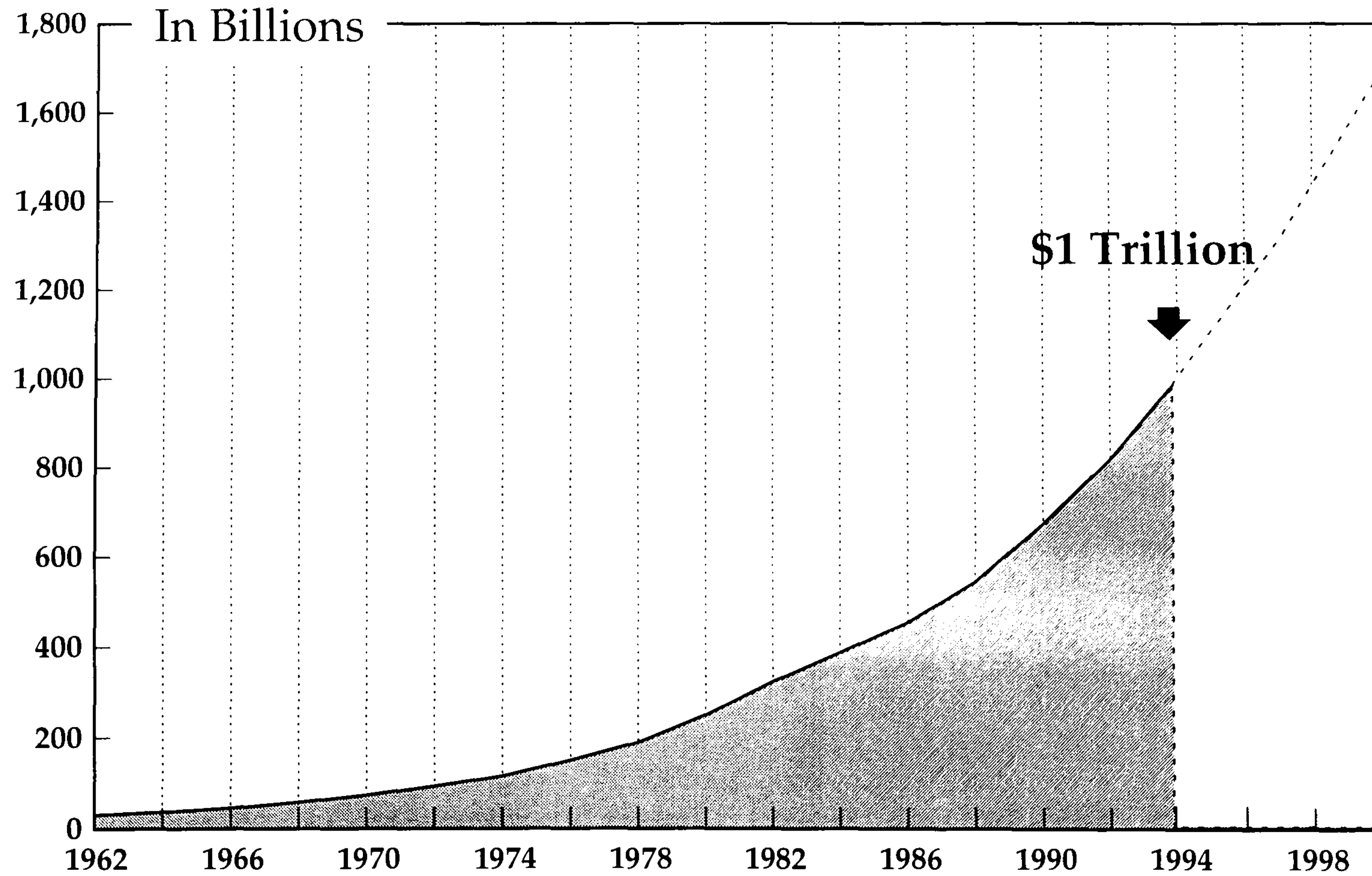




More Americans Lack Health Security
Percent of population without insurance
16
14
12
10
8
6
4
2
0
14.7%
0.5%
1.0%
Canada
Denmark
France
Germany
Sweden
Japan
United Kingdom
United States
Source: Organization of Economic Cooperation and Development

National Health Spending

The U.S. will have a $1 trillion health care bill next year



REVENUE PROPOSALS IN HEALTH SECURITY ACT

oposal 1/	Effective Date	1994	1995	1996	1997	1998	1999	2000	1994–00
					Fiscal years ($ millions)				
1 Increase in tax on tobacco products	10/1/94	0	12,269	11,107	10,866	10,613	10,348	10,074	65,277
2 Assessment on corporate alliance employers	1/1/96	0	0	3,750	4,940	5,060	5,120	5,210	24,080
3 Health insurance									
a Increase in deduction for health insurance costs of self–employed individuals	1/1/94	–100	–500	–600	–900	–1,700	–2,900	–3,100	–9,800
b Limitations on exclusion of employer–provided health coverage in cafeteria plans	1/1/97 /2	0	0	0	5,000	7,700	8,300	8,900	29,900
4 Long–term care									
a Qualified long–term care services treated as medical care	1/1/96	0	0	–68	–172	–179	–186	–194	–799
b Treatment of long–term care insurance	1/1/96	0	0	–87	–249	–341	–437	–532	–1,646
c Tax treatment of accelerated death benefits	1/1/94	–1	–3	–3	–4	–5	–6	–7	–29
d Credit for cost of personal assistance service required by employed individuals	1/1/96	0	0	–23	–118	–125	–134	–143	–543
5 Tax incentives for health service providers in shortage areas									
a Tax credit for health professionals	1/1/95	0	0	–2	–5	–8	–11	–15	–41
b Expensing for medical equipment	1/1/95	0	–10	–17	–10	–6	–4	–2	–48
6 Compliance									
a Modification to self–employment tax treatment of certain S corporation shareholders and partners	1/1/96	0	0	158	487	509	526	544	2,224
b Modification to penalty for failure to report payments made to independent contractors	30 days after d/o/e	0	53	74	76	80	84	88	455
7 Post–retirement medical and life insurance reserves and retiree health accounts maintained by pension plans	1/1/95	0	21	35	43	51	59	67	276
8 Tax treatment of health care organizations	1/1/97	0	0	0	96	169	186	205	656
TOTAL (REVENUE PROPOSALS):		–101	11,830	14,324	20,050	21,818	20,945	21,095	109,962
Effects of employer mandate, cost containment, and subsidies on income and payroll taxes	10/1/95	0	0	–100	700	3,600	8,000	10,800	23,000

Department of the Treasury
Office of Tax Analysis

November 2, 1993

Notes: 1/ Estimates are not broken out between on–budget and off–budget effects.
2/ Limitations on the exclusion for supplemental health coverage (including employer–paid copays and deductibles) will be effective in 2003.

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

STATEMENT OF

THE HONORABLE FRANK N. NEWMAN

UNDER SECRETARY OF THE TREASURY

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

November 3, 1993

Chairman Riegle, Senator D'Amato, and members of the committee, I am pleased to be here today at your request to discuss the Administration's views on interstate banking and bank insurance activities, two topics we believe are conceptually distinct and should be dealt with separately.

I am not here today to call for precipitous action in either area. As Secretary Bentsen declared last week, "this Administration will take a deliberate, disciplined approach that will produce more and better results over time. We will focus on achievable goals and pick targets carefully. We will build consensus, issue by issue. And we will listen seriously to the concerns of all those with a genuine public policy interest in an issue." The Secretary called for quick action on three bills already before the Congress. These bills involve RTC funding,

LB-477

community development financial institutions, and fair trade in financial services.

I. Reasons to Relax Geographic Restrictions

U.S. geographic restrictions are unique among the industrialized nations of the world, and many observers consider them among the least defensible of our banking laws. The Administration supports the idea of reducing these restrictions. In my testimony today I will discuss the reasons behind our thinking, analyze the concerns most commonly raised, and provide the Administration's views on key issues.

Geographic restrictions on commercial banks originated in the earliest days of American banking to protect banks from competition and preserve local markets for local banks. However, these restrictions warrant reassessment because financial markets and institutions, and the economy itself, have evolved dramatically since then.

We find the current framework of geographic restrictions no longer appropriate, for several reasons. First, modern banks operate beyond local markets, and they compete with non-bank institutions that face no similar geographic restrictions. Second, the states themselves have relaxed geographic barriers. Third, removing these restrictions could improve the safety and

soundness of the banking system. Fourth, the public could benefit from greater competition, improved bank performance, and greater customer convenience. Finally, removing geographic restrictions would let banks structure themselves more efficiently, which could ultimately permit banks to make more credit available to businesses and individuals.

Current Operating Realities

Banking organizations can no longer be defined in terms of the limited services and facilities considered appropriate in past generations. New realities are evident on both sides of the banking balance sheet. For example, on the liability side of the balance sheet, banks fund themselves not only with traditional (local) retail deposits, but also with large negotiable certificates of deposit, foreign deposits, Eurodollar borrowings, Fed funds, repurchase agreements, and debt and equity issues, among others. These funding transactions can involve local, regional, national, and international financial markets.

On the asset side, large banks have for many years reached for business opportunities beyond local markets. Real estate loans, commercial loans, foreign government loans, securitized loans, and various types of loan participations typically require involvement in non-local markets. The same is true of such other services as money management, cash management, electronic funds

transfers, private placements, credit card distributions, foreign exchange dealing, and various risk management activities.

Further, geographic restrictions keyed to local markets have proven porous. They apply to brick-and-mortar branches but not to loan productions offices, Edge Act corporations, or mortgage finance, consumer finance, or securities brokerage subsidiaries -- which banks and bank holding companies may establish anywhere, without regard to state boundaries or intrastate branching restrictions. Moreover, numerous bank holding companies have used grandfather rights, emergency acquisitions, and evolving state laws to establish extensive, though unwieldy interstate banking networks.

Non-Bank Institutions. Many non-bank financial institutions offer products that compete directly with bank services. Yet these non-banks can operate more efficiently because they face no geographic restrictions. Federally chartered thrift institutions can branch nationwide. Federal credit unions can do likewise, so long as their members share the requisite common bond. Mutual funds, many of which offer check-writing and other consumer conveniences, have become the most notable substitute for insured deposits. Securities firms also compete for savers' funds by offering cash management accounts, with check-writing and credit card features, through large networks of geographically dispersed offices. Insurance companies provide a bank-like savings service

nationwide through insurance policies with redeemable cash value; and they compete directly with banks in making large commercial and real estate loans. Other major competitors that operate free from geographic restrictions include consumer, business, and sales finance companies; mortgage companies; the captive finance firms of automobile and appliance manufacturers; and retail credit grantors.

On balance, geographic restrictions have outlived their usefulness and no longer reflect bank practice or competition. Rather, they require banks to organize themselves in cumbersome and inefficient ways to compete.

The Trend Among the States

The states have already come to recognize the inefficiencies of geographic restrictions. For example, as recently as 1980, over half of the states retained highly restrictive intrastate branching rules. Since 1980, however, branching rules have loosened considerably. Today, 46 states (plus the District of Columbia) permit statewide branching. Four states continue with limited branching, and no state retains unit banking -- the old policy of allowing banks to have only one office.

Interstate banking, in which bank holding companies own banks in different states, has developed even more dramatically.

From the time of the Bank Holding Company Act of 1956 to the mid-1980s, interstate banking barely existed, and then only through grandfathering or other limited exceptions. But once the Supreme Court upheld New England's regional interstate banking compact in 1985, the states rapidly implemented interstate banking. Currently, all states but Hawaii allow out-of-state bank holding companies to acquire banks within the state. However, these laws vary considerably from state to state. Consequently, we lack a uniform, efficient, and truly national approach to interstate banking.

Several factors help to explain the 1980s trend toward easing geographic restrictions on banks. First, the states sought to attract and pool capital to support their economic growth and development. Second, the federal government as well as the states needed to facilitate the resolution of troubled banks and thrifts by permitting acquisitions by out-of-state institutions. And third, banks made an increasingly cogent case for competitive equity vis-a-vis their non-bank competitors.

Safety and Soundness

Relaxing geographic restrictions will tend to promote a safer and sounder banking system. Allowing banks to diversify their assets geographically allows them to diversify their income stream and make it more stable than that from any one geographic

area. Geographically limited banks have earnings more susceptible to the vagaries of local market cycles, which renders such banks more likely to fail. Indeed, regional economic downturns figured prominently among the causes of many of the bank failures of the 1980s.

Geographic diversification also facilitates developing a strong retail deposit base, which represents additional protection against failure. Historically, banks heavily dependent on purchased funds have shown heightened vulnerability to rapid deposit outflows. Banks with a large, geographically diverse retail deposit base have been better able to avoid or withstand liquidity problems.

Finally, to the extent that interstate consolidation reduces bank operating costs, it would help banks build or maintain capital, directly contributing to overall safety and soundness.

Efficiency and Cost Savings

Many banks and bank analysts argue that consolidating banks into branches across state lines would yield major cost savings, as banks eliminated duplicative functions and reduced expenses. While the extent of the savings may vary from one bank to another, we are convinced that many banks can realize very substantial efficiencies. Moreover, the fact that savings may

vary across banks in no way warrants denying banks an opportunity to realize these savings.

II. Concerns Raised by Geographic Liberalization

A number of concerns are commonly raised about geographic liberalization. Included among these are that liberalization might: (1) lead to a decline in the number of small banks; (2) result in an excessive concentration of resources; (3) siphon credit from local communities; and (4) damage the dual banking system. I would like to discuss each of these concerns in turn.

Decline in Small Banks

Among the most frequently voiced concerns is that interstate branching will inevitably reduce the number of small banks: large institutions will enter local markets and drive out, or buy up, all the small community banks. However, ample evidence indicates that this outcome is not inevitable or even likely. For example, small banks have continued to prosper in states, such as New York, that over the years significantly reduced intra- and interstate geographic restrictions.

Even in states that have long had liberal branching laws, small banks prosper and compete successfully with large banks. For example, in my home state of California, which has had

unrestricted branching since the early 1900s, hundreds of small banks, as well as many thrifts and credit unions, operate alongside large banking organizations with their far-reaching branch networks. Other states that have long permitted extensive branching, such as New Jersey and North Carolina, also have strong small bank communities.

Thus, fears that relaxing geographic restrictions will undermine the viability of small banks and the maintenance of competition are, we believe, ill-founded. Over the years small banks have been among the most profitable and best-capitalized banks in the nation. Well-managed small banks that know and meet their customers' needs can flourish without geographic barriers to entry. Moreover, the availability of new bank charters will help to maintain a reasonable balance between large bank organizations and small, independent institutions.

Concentration of Resources

A longstanding concern about removing geographic restrictions involves the potential concentration of banking resources and its effects on competition. While this concern cannot be dismissed lightly, new measures to limit concentration are unnecessary. Despite progressive consolidation at the state and national levels, the level of concentration in local urban

and rural markets has remained virtually unchanged for almost two decades.

Indeed, we believe the issue of market share limits (and other proposed concentration safeguards) demands further analysis. As I discussed earlier, modern banks engage in a wide variety of activities in competition with a wide variety of non-bank financial intermediaries. Because of this, determining the appropriate limits on market share, or even the proper definition of the market, can be complicated. Among other things, serious questions would need to be answered involving the size of market, the range of institutions covered, and the degree of uniformity of limits across different jurisdictions. For example, savers can place their funds in banks, thrifts, credit unions, mutual funds, and other entities, including money-market funds with check-writing capabilities. Without good answers to the above questions, market share limits would not yield the intended effect. For these reasons, we believe it is better to continue to rely on detailed reviews of specific merger and acquisition transactions by the appropriate federal agencies and the Department of Justice, in order to assure competitive markets.

Local Reinvestment

Another concern raised is that interstate branching may undermine the intent of the Community Reinvestment Act of 1977,

and siphon funds from local communities. But interstate branching legislation need not alter the CRA: all existing requirements for community reinvestment will remain intact and serve to ensure that banks meet local credit obligations. Moreover, we find no firm foundation for asserting that branch banking is more likely than other banking structures to divert funds from local communities. On the contrary, the historical evidence shows generally higher bank loan-to-asset and loan-to-deposit ratios in jurisdictions with more liberal branching.

Indeed, the propensity to export capital or lend locally is unrelated to bank branching structure. For example, a community bank not wishing to lend locally -- or not finding sufficient local loan demand -- can already sell Fed funds upstream to a correspondent bank, buy securities, or participate in loans originated by banks located elsewhere.

Finally, the siphoning argument amounts to a double-edged sword: a bank can also inject credit into an area, and bring funds into local communities. This is among the reasons why states have liberalized their branching and interstate banking laws. That is, broader geographic expansion authority can produce more efficient credit distribution, including a greater flow of funds to communities with the greatest credit demand.

The Dual Banking System

An often-raised concern is that interstate branching might damage the dual banking system, but this should not happen. Current legislative proposals for interstate branching generally preserve states' authority to determine banking structure and otherwise regulate financial institutions within their jurisdiction. Under these proposals states would retain their current authority to control branching within their borders by national and state banks, and to limit interstate branching by their own state banks. These proposals also permit states to impose on banks and branches within their borders certain state laws regarding fair lending practices, unsafe and unsound banking practices, and community reinvestment requirements (as if the bank were headquartered in the host state).

III. Administration Views on Geographic Restrictions

As I mentioned earlier, the Administration supports the idea of further relaxing geographic restrictions. But in that process, we believe that certain principles should be followed. The principles include: (1) promoting efficiency and competition; (2) protecting safety and soundness; (3) meeting consumer and community needs; and (4) respecting the interests of the states. Additionally, we believe that any legislation in this Congress to relax geographic restrictions should be kept

separate from other issues so that it can be considered on its own merits.

One approach to reducing geographic restrictions that would accord with these principles would be for Congress to:

- permit any bank holding company to acquire a bank in any other state, unless that state opted out of such interstate acquisitions;

- permit the out-of-state holding company to consolidate any subsidiary bank with any of the holding company's other subsidiary banks, and thus convert the bank's offices into branches of the consolidated bank, unless the state opted out of such interstate consolidations; and

- permit the consolidated bank to branch within the state to the same extent as a state bank chartered in that state.

Such legislation could take effect some time (e.g., 18 months) after enactment. States could opt out at any time after enactment. If a state did opt out of interstate acquisitions or consolidations, it would seem only fair that its bank holding companies would be ineligible to engage in such transactions

themselves. In any event, opting out would not invalidate any acquisition or consolidation that was lawful when made.

This approach would permit banking organizations to structure themselves more efficiently and thus reduce their operating costs. And it would benefit consumers and businesses through lower costs and greater convenience in the market for financial services. Consolidating a bank holding company's interstate banks would not change the amount of banking assets under common control, and should raise no new issues regarding concentration. The acquisition of new offices would be subject to concentration and competitive effects analysis by federal agencies, as is currently the case.

Any relaxation of geographic restrictions should not be allowed to undermine banks' obligation to serve their local communities. In this respect, it is useful to emphasize that all existing CRA requirements will remain in effect. A related concern is that interstate consolidation of banks into branch systems might reduce the information available on banks in their communities. We believe that an appropriate response to this concern is a separate CRA evaluation for each metropolitan area; this matter will be addressed in the new performance-based CRA approach that the regulatory agencies are currently developing.

Finally, any relaxation of geographic restrictions should accord foreign banks national treatment -- the same competitive opportunities as U.S. banks.

In sum, we believe relaxing current geographic restrictions should yield a number of benefits. Banks could benefit from greater efficiency. Businesses and consumers could benefit from less costly financial services, and greater locational and product convenience. And the banking system could benefit from improved safety and soundness.

IV. Insurance Activities

When considering appropriate activities for commercial banks, our two standard questions stand out in importance. First, does the activity contribute to the safety and soundness of the banking system? Second, does it on balance offer benefits to consumers? Sale of insurance by banks under current law, conducted appropriately, can meet these tests.

Safety and Soundness

Recent experience demonstrates that the banking industry is not immune to economic difficulties. In fact, the industry has suffered long term decline in the face of stiff competition from many less-regulated providers of financial services. On the

asset side of the balance sheet, loans have been lost to the commercial paper market, commercial finance companies, insurance companies, and other competitors. On the liability side, funds have flowed in large amounts from bank deposits to mutual funds and other financial assets provided by competing firms.

Thus, in spite of today's healthy profits, we cannot be indifferent to the long-term strength of the banking industry. For many consumers, businesses, and communities it remains the most important source of financial services. Banks provide such basic financial services as savings and transaction accounts, bill paying, and check cashing, which many individuals and businesses critically need. Banks extend loans to small businesses that may otherwise lack access to capital. And they generally support local communities in ways foreign to more specialized financial intermediaries.

We believe that national banks' insurance activities under current law pose no safety and soundness problems. In selling insurance, banks do not assume the risk of insurance underwriters, and banks' capital remains unimpaired. This stands in sharp contrast to bank loans, where the bank typically assumes the entire risk of default. Moreover, insurance sales can provide banks with the benefits of diversification. Such diversification tends to increase and stabilize overall bank earnings, and thus contributes to bank safety and soundness.

Such stability can help enable banks to provide more credit to borrowers, even in hard times.

Consumer Benefits

We believe bank sales of insurance can benefit consumers through lower prices and greater convenience. In particular, a wider variety of bank products and services allows banks to reduce overhead costs per unit sold. Insurance sales by banks, appropriately conducted, can also benefit consumers by reducing the time and effort expended in purchasing insurance. Bank facilities are conveniently located for most consumers, and banks could provide one-stop shopping for both banking and insurance needs.

Greater convenience may be most important to consumers and small businesses in remote areas or low-income communities, where the availability of financial services may be more limited. This is one reason why current law permits national banks to engage in general insurance sales in small towns. Another reason is that the opportunity for such sales can encourage banks to locate or expand their operations in small towns. For similar reasons, we believe it may make sense to explore the idea of permitting national banks to sell insurance in low-income, inner-city neighborhoods.

On balance, we believe that selling insurance entails minimal risk for banks. In addition, we believe that consumers may benefit through increased services, greater convenience, and potentially lower insurance prices.

S. 543

We are concerned that certain of S. 543's insurance provisions may move us in the wrong direction. They would significantly restrict banks' authority to sell insurance from small towns. Today national banks located in small towns can sell insurance nationwide. S. 543 would generally confine that authority to the town and its contiguous rural areas. Such a curtailment may be enough to diminish many banks' economic incentives to locate in and provide insurance services to such areas.

Another provision of S. 543 would suspend the Comptroller of the Currency's authority under national banking law to approve bank insurance activities that are incidental to the business of banking. We see no need for this provision. Banks could lose opportunities to diversify services and stabilize earnings, contributing to banking system weakness. And consumers could lose the price, availability, and convenience benefits of more competitive insurance markets.

For these reasons, we do not believe that the current insurance activities of national banks should be limited.

V. Conclusion

Mr. Chairman, I commend you and the other members of the committee for the seriousness and commitment you bring to these important issues. We very much look forward to working with you.

I would be pleased to respond to any questions you might have.

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

FOR RELEASE AT 2:30 P.M.
November 2, 1993

CONTACT: Office of Financing
202/219-3350

TREASURY TO AUCTION CASH MANAGEMENT BILL

The Treasury will auction approximately $10,000 million of 36-day Treasury cash management bills to be issued November 10, 1993.

Competitive tenders will be received at all Federal Reserve Banks and Branches. Noncompetitive tenders will not be accepted. Tenders will not be received at the Bureau of the Public Debt, Washington, D. C.

Additional amounts of the bills may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular (31 CFR Part 356, published as a final rule on January 5, 1993, and effective March 1, 1993) for the sale and issue by the Treasury to the public of marketable Treasury bills, notes, and bonds.

Details about the new security are given in the attached offering highlights.

oOo

Attachment

HIGHLIGHTS OF TREASURY OFFERING
OF 36-DAY CASH MANAGEMENT BILL

November 2, 1993

Offering Amount . . . . $10,000 million

Description of Offering:

Term and type of security	36-day Cash Management Bill
CUSIP number	912794 E6 7
Auction date	November 4, 1993
Issue date	November 10, 1993
Maturity date	December 16, 1993
Original issue date	December 17, 1992
Currently outstanding	$38,213 million
Minimum bid amount	$1,000,000
Multiples	$1,000,000
Minimum to hold amount	$10,000
Multiples	$1,000

Submission of Bids:

Noncompetitive bids . . . . Not accepted

Competitive bids . . .
(1) Must be expressed as a discount rate with two decimals, e.g., 7.10%.
(2) Net long position for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position is $2 billion or greater.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Maximum Recognized Bid at a Single Yield . . . 35% of public offering

Maximum Award . . . . 35% of public offering

Receipt of Tenders:

Noncompetitive tenders . . Not accepted

Competitive tenders . . . . Prior to 1:00 p.m. Eastern Standard time on auction day

Payment Terms . . . . Full payment with tender or by charge to a funds account at a Federal Reserve Bank on issue date

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

FOR RELEASE AT 2:30 P.M.
November 2, 1993

CONTACT: Office of Financing
202/219-3350

TREASURY'S WEEKLY BILL OFFERING

The Treasury will auction two series of Treasury bills totaling approximately $27,600 million, to be issued November 12, 1993. This offering will provide about $3,525 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $24,083 million.

Federal Reserve Banks hold $5,895 million of the maturing bills for their own accounts, which may be refunded within the offering amount at the weighted average discount rate of accepted competitive tenders.

Federal Reserve Banks hold $2,001 million as agents for foreign and international monetary authorities, which may be refunded within the offering amount at the weighted average discount rate of accepted competitive tenders. Additional amounts may be issued for such accounts if the aggregate amount of new bids exceeds the aggregate amount of maturing bills.

Tenders for the bills will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular (31 CFR Part 356, published as a final rule on January 5, 1993, and effective March 1, 1993) for the sale and issue by the Treasury to the public of marketable Treasury bills, notes, and bonds.

Details about each of the new securities are given in the attached offering highlights.

oOo

Attachment

LB-479

HIGHLIGHTS OF TREASURY OFFERINGS OF WEEKLY BILLS
TO BE ISSUED NOVEMBER 12, 1993

November 2, 1993

Offering Amount	$13,800 million	$13,800 million
Description of Offering:		
Term and type of security	90-day bill	181-day bill
CUSIP number	912794 H8 0	912794 K5 2
Auction date	November 8, 1993	November 8, 1993
Issue date	November 12, 1993	November 12, 1993
Maturity date	February 10, 1994	May 12, 1994
Original issue date	February 11, 1993	November 12, 1993
Currently outstanding	$27,365 million	---
Minimum bid amount	$10,000	$10,000
Multiples	$ 1,000	$ 1,000

The following rules apply to all securities mentioned above:

Submission of Bids:

Noncompetitive bids . . . . Accepted in full up to $1,000,000 at the average discount rate of accepted competitive bids

Competitive bids . . . .
(1) Must be expressed as a discount rate with two decimals, e.g., 7.10%.
(2) Net long position for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position is $2 billion or greater.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Maximum Recognized Bid at a Single Yield . . . . 35% of public offering

Maximum Award . . . . 35% of public offering

Receipt of Tenders:

Noncompetitive tenders . . . . Prior to 12:00 noon Eastern Standard time on auction day

Competitive tenders . . . . Prior to 1:00 p.m. Eastern Standard time on auction day

Payment Terms . . . . Full payment with tender or by charge to a funds account at a Federal Reserve Bank on issue date

Financing Health Care Reform

02-Nov-93

Sources of Funds (billions of dollars)

Fiscal Years	1995	1996	1997	1998	1999	2000	1995-00
Medicare Savings	2.5	10.0	15.2	23.0	32.4	40.3	123.4
Part A	0.0	4.1	7.4	12.3	16.3	20.2	60.3
Part B	1.6	2.2	3.7	7.1	9.6	10.5	34.7
Parts A and B	0.9	1.9	1.6	1.2	4.1	7.1	16.9
HI Tax Extended to all State & Local Government Employees	0.0	1.5	1.5	1.5	1.4	1.4	7.3
Income Related SMI Premium with outlay and premium effects	0.0	0.4	0.9	0.9	1.0	1.1	4.2
Medicaid Savings	0.0	1.0	3.9	10.4	22.2	27.8	65.3
Savings from Capitation of Cash-Eligible Beneficiaries	0.0	0.3	1.2	3.9	6.7	10.2	22.3
Reduced Disproportionate Share Hospital Payments	0.0	1.4	4.7	13.0	16.8	18.6	54.5
less Offset for Reserve	0.0	-0.2	-0.4	-1.0	-1.0	-1.0	-3.6
Less Wrap-around Benefits (net of offset)	0.0	-0.1	-0.6	-1.5	-1.9	-1.9	-6.0
Payment Lag, Administrative Savings, and Other Changes	0.0	-0.4	-1.0	-4.0	1.5	1.9	-2.0
Tobacco Tax/ Corporate Assessment	12.3	14.9	15.8	15.7	15.5	15.3	89.4
Tobacco Tax	12.3	11.1	10.9	10.6	10.3	10.1	65.3
Corporate Assessment	0.0	3.8	4.9	5.1	5.1	5.2	24.1
Other Federal Savings	0.0	1.0	2.8	10.1	12.2	13.5	39.6
Veterans Affairs (b)	0.0	0.6	1.7	4.3	4.5	4.7	15.8
Defense Department Health (a)	0.0	0.1	0.2	0.7	0.8	0.8	2.6
Federal Employees Health Benefits	0.0	0.0	0.0	3.3	4.5	5.4	13.2
Public Health Service Savings	0.0	0.3	0.9	1.8	2.4	2.6	8.0
Other Revenue Effects	0.1	0.1	6.4	14.5	21.6	25.4	68.1
Effects of Mandate, Cost Containment, and Subsidies	0.0	-0.1	0.7	3.6	8.0	10.8	23.0
Exclusion of Health Insurance from Cafeteria Plans	0.0	0.0	5.0	7.7	8.3	8.9	29.9
Incentives for Health Providers in Shortage Areas	-0.0	-0.0	-0.0	-0.0	-0.0	-0.0	-0.1
Anti-Abuse Rule -- Certain S Corp. Shareholders	0.0	0.2	0.5	0.5	0.5	0.5	2.2
Reporting Penalties -- Non-corp. Ind. Contractors	0.1	0.1	0.1	0.1	0.1	0.1	0.5
Modify Tax Treatment of Certain Health Care Orgs.	0.0	0.0	0.1	0.2	0.2	0.2	0.7
Modify Tax Treatment Retirement Funding Accounts	0.0	0.0	0.0	0.1	0.1	0.1	0.3
Assessment on Employers for Retiree Subsidies	0.0	0.0	0.0	2.4	4.4	4.7	11.4
Recapture Retiree Subsidies High-Income Recipients	0.0	0.0	0.0	0.0	0.1	0.1	0.2
Debt Service	0.3	0.6	0.6	0.3	0.6	2.1	4.3
TOTAL	15.1	27.6	44.7	73.9	104.5	124.3	390.1

(a) Under the proposed legislation, the Secretary of Defense is to decide when the military system will be coordinated with national health reform. This table shows the estimated budgetary effects on the Department of Defense if the military system were to be fully coordinated with national health reform by FY 1998.

(b) New receipts to reimburse veterans expenses

LB-480

Financing Health Care Reform

02-Nov-93

Uses of Funds (billions of dollars)

Fiscal Years	1995	1996	1997	1998	1999	2000	1995-00
Public Health/Administration	**3.6**	**5.3**	**5.9**	**5.6**	**5.3**	**5.4**	**31.1**
WIC Enhancement	0.0	0.5	0.6	0.6	0.7	0.7	3.1
New Public Health Initiatives	0.4	1.5	2.6	3.3	3.7	3.8	15.3
Net New Spending on Acad. Health Ctrs. and Medical Educ.	0.0	2.2	1.4	-0.1	-0.1	-0.2	3.2
Total Spending	5.9	6.3	6.7	8.0	9.5	9.6	46.0
Less Current Medicare Funding	-5.9	-3.6	-3.6	-3.6	-4.0	-3.9	-24.6
Less Premium Offset	0.0	-0.5	-1.7	-4.5	-5.6	-5.9	-18.2
New Federal Administrative and Start-Up Costs	3.2	1.2	1.3	1.8	1.1	1.1	9.6
Long-Term Care	**0.0**	**5.7**	**9.3**	**12.7**	**16.5**	**20.6**	**64.7**
Net Home Based Care for the Disabled	0.0	4.5	7.8	11.0	14.7	18.7	56.7
Total Spending	0.0	6.9	11.2	14.7	18.7	23.0	74.5
Medicaid Offset	0.0	-2.4	-3.4	-3.7	-4.0	-4.3	-17.8
Liberalized Medicaid Eligibility	0.0	1.0	1.0	1.0	1.0	1.0	5.0
Tax Incentives for Long-term Care	0.0	0.2	0.5	0.7	0.8	0.9	3.0
Medicare Drug Benefit	**0.0**	**6.6**	**13.5**	**14.2**	**15.2**	**16.2**	**65.8**
Benefits, Administration, and Pharmacists Costs	0.0	8.2	16.3	17.5	18.7	20.0	80.8
Less Rebate	0.0	-1.6	-2.8	-3.3	-3.5	-3.8	-15.0
100% Tax Deduction for Self-Employed Health Insurance	**0.5**	**0.6**	**0.9**	**1.7**	**2.9**	**3.1**	**9.7**
Premium Discounts (Subsidies)	**0.0**	**7.3**	**18.4**	**47.8**	**44.4**	**43.2**	**161.1**
Premium Discounts (Subsidies) -- Net of Cushion	0.0	5.7	13.9	35.6	31.7	30.1	117.0
Capped Entitlement for Premium Discounts	0.0	10.3	28.3	75.6	78.9	81.0	274.1
Total Discounts (Subsidies)	0.0	12.8	35.7	96.3	100.6	103.6	349.0
Employers (net of cushion)	0.0	3.9	10.9	27.9	28.3	28.6	99.6
Non-retired Households (net of cushion)	0.0	6.0	16.7	43.7	45.5	47.3	159.3
Retirees -- low income subsidies (net of cushion)	0.0	0.9	2.6	6.9	7.2	7.4	25.0
Retirees -- added subsidies (net of cushion)	0.0	0.0	0.0	3.0	4.2	4.4	11.6
Out-of-Pocket	0.0	0.3	1.0	2.6	2.7	2.8	9.4
Total "Cushion"	0.0	1.6	4.5	12.2	12.7	13.1	44.0

Financing Health Care Reform

02-Nov-93

Uses of Funds (billions of dollars)

Fiscal Years	1995	1996	1997	1998	1999	2000	1995-00
Less Offsets	0.0	-5.5	-17.3	-48.5	-56.2	-60.4	-187.9
States' Required Maintenance of Effort	0.0	-2.5	-7.4	-20.7	-21.7	-22.6	-74.9
Discontinued Medicaid Coverage	0.0	-2.0	-6.9	-19.8	-26.5	-29.8	-85.0
Basic Benefits	0.0	-1.9	-6.5	-18.5	-24.7	-27.9	-79.5
Net Wrap-around Benefits	0.0	-0.1	-0.4	-1.3	-1.8	-1.9	-5.5
Medicare Offset for Employed Beneficiaries	0.0	-1.0	-3.0	-8.0	-8.0	-8.0	-28.0
Total Spending	**4.1**	**25.5**	**48.1**	**82.0**	**84.3**	**88.4**	**332.4**
Deficit Reduction	**11.0**	**2.1**	**-3.4**	**-8.1**	**20.2**	**35.8**	**57.7**
TOTAL	**15.1**	**27.6**	**44.7**	**73.9**	**104.5**	**124.3**	**390.1**

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
November 3, 1993

CONTACT: Office of Financing
202/219-3350

TREASURY NOVEMBER QUARTERLY FINANCING

The Treasury will auction $17,000 million of 3-year notes, $12,000 million of 9-3/4-year 5-3/4% notes, and $14,000 million of 66-day cash management bills to refund $32,221 million of publicly-held securities maturing November 15, 1993, and to raise about $10,775 million new cash. Details about the cash management bill are given in a separate announcement.

In addition to the public holdings, Federal Reserve Banks hold $6,495 million of the maturing securities for their own accounts, which may be refunded by issuing additional amounts of the new securities.

The maturing securities held by the public include $2,760 million held by Federal Reserve Banks as agents for foreign and international monetary authorities. Amounts bid for these accounts by Federal Reserve Banks will be added to the offering.

The 9-3/4-year note being offered today is eligible for the STRIPS program.

Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular (31 CFR Part 356, published as a final rule on January 5, 1993, and effective March 1, 1993) for the sale and issue by the Treasury to the public of marketable Treasury bills, notes, and bonds.

Details about the notes are given in the attached offering highlights.

oOo

Attachment

LB-481

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC

NOVEMBER 1993 QUARTERLY FINANCING

November 3, 1993

Offering Amount	$17,000 million	$12,000 million
Description of Offering:		
Term and type of security	3-year notes	9-3/4-year notes (reopening)
Series	Series AB-1996	Series B-2003
CUSIP number	912827 M7 4	912827 L8 3
Auction date	November 9, 1993	November 10, 1993
Issue date	November 15, 1993	November 15, 1993
Dated date	November 15, 1993	August 15, 1993
Maturity date	November 15, 1996	August 15, 2003
Interest rate	Determined based on the average of accepted competitive bids	5-3/4%
Yield	Determined at auction	Determined at auction
Interest payment dates	May 15 and November 15	February 15 and August 15
Minimum bid amount	$5,000	$1,000
Multiples	$1,000	$1,000
Accrued interest payable by investor	None	$14.375 per $1,000 (from August 15 to November 15, 1993)
Premium or discount	Determined at auction	Determined at auction
STRIPS Information:		
Minimum amount required	Not applicable	$800,000
Corpus CUSIP number	Not applicable	912820 BG 1
New TINT CUSIP number	Not applicable	Not applicable
New TINT due date	Not applicable	Not applicable

The following rules apply to all securities mentioned above:

Submission of Bids:

Noncompetitive bids . . . . Accepted in full up to $5,000,000 at the average yield of accepted competitive bids.

Competitive bids . . . . (1) Must be expressed as a yield with two decimals, e.g., 7.10%.
(2) Net long position for each bidder must be reported when the sum of the total bid amount, at all yields, and the net long position is $2 billion or greater.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Maximum Recognized Bid at a Single Yield . . . . 35% of public offering

Maximum Award . . . . 35% of public offering

Receipt of Tenders:

Noncompetitive tenders . . . . . . Prior to 12:00 noon Eastern Standard time on auction day

Competitive tenders . . . . Prior to 1:00 p.m. Eastern Standard time on auction day

Payment Terms . . . . Full payment with tender or by charge to a funds account at a Federal Reserve Bank on issue date

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
November 3, 1993

CONTACT: Office of Financing
202/219-3350

TREASURY TO AUCTION CASH MANAGEMENT BILL

The Treasury will auction approximately $14,000 million of 66-day Treasury cash management bills to be issued November 15, 1993.

Competitive and noncompetitive tenders will be received at all Federal Reserve Banks and Branches. Tenders will not be accepted for bills to be maintained on the book-entry records of the Department of the Treasury (TREASURY DIRECT). Tenders will not be received at the Bureau of the Public Debt, Washington, D.C.

Additional amounts of the bills may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular (31 CFR Part 356, published as a final rule on January 5, 1993, and effective March 1, 1993) for the sale and issue by the Treasury to the public of marketable Treasury bills, notes, and bonds.

Details about the new security are given in the attached offering highlights.

oOo

Attachment

LB-482

HIGHLIGHTS OF TREASURY OFFERING
OF 66-DAY CASH MANAGEMENT BILL

November 3, 1993

Offering Amount . . . . . . $14,000 million

Description of Offering:

Term and type of security	66-day Cash Management Bill
CUSIP number	912794 H5 6
Auction date	November 9, 1993
Issue date	November 15, 1993
Maturity date	January 20, 1994
Original issue date	July 22, 1993
Currently outstanding	$25,630 million
Minimum bid amount	$10,000
Multiples	$1,000
Minimum to hold amount	$10,000
Multiples to hold	$1,000

Submission of Bids:

Noncompetitive bids . . . . Accepted in full up to $1,000,000 at the average discount rate of accepted competitive bids

Competitive bids . . .
(1) Must be expressed as a discount rate with two decimals, e.g., 7.10%.
(2) Net long position for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position is $2 billion or greater.
(3) Net long position must be determined as of one half-hour prior to the closing time for receipt of competitive tenders.

Maximum Recognized Bid at a Single Yield . . . 35% of public offering

Maximum Award . . . . 35% of public offering

Receipt of Tenders:

Noncompetitive tenders . . Prior to 11:00 a.m. Eastern Standard time on auction day

Competitive tenders . . . . Prior to 11:30 a.m. Eastern Standard time on auction day

Payment Terms . . . . Full payment with tender or by charge to a funds account at a Federal Reserve Bank on issue date

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

FOR IMMEDIATE RELEASE
November 3, 1993

CONTACT: Scott Dykema
(202)622-2960

BENTSEN CALLS HEALTH CARE REFORM KEY ECONOMIC STRATEGY

Treasury Secretary Lloyd Bentsen Wednesday said health care reform is a top priority and a key part of President Clinton's overall economic strategy.

"From an economic standpoint, failing to act is just not an option. When employers pay their workers more but health care costs continue to rise, workers' paychecks just do not go up as they should," Bentsen told the Senate Finance Committee. Some forecasts predict that if nothing is done, Bentsen said, "every bit and more of projected wage increases in the coming decade could be consumed by health care costs."

Bentsen said the President's health reform plan will be responsibly financed. "Our plan is the only comprehensive proposal that spells out exactly what will be provided and exactly how it will be financed, and that's the fiscally responsible way to do it," he said.

"I'm enthusiastically here in support of what we are presenting," Bentsen said. "It clearly spells out the costs to the federal government and how we're going to pay for them, including discounts to eligible businesses and individuals, long-term care and the new Medicare drug benefit."

Bentsen, in releasing detailed revenue and spending estimates of the plan, said: "Only the President's plan is truly universal and comprehensive. The administration has offered a bold and comprehensive plan to give Americans health security and to take charge of health care costs."

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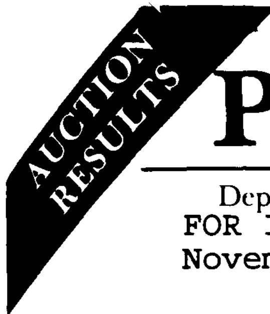


PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
November 4, 1993

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 36-DAY BILLS

Tenders for $10,045 million of 36-day bills to be issued November 10, 1993 and to mature December 16, 1993 were accepted today (CUSIP: 912794E67).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	3.03%	3.08%	99.697
High	3.04%	3.09%	99.696
Average	3.04%	3.09%	99.696

Tenders at the high discount rate were allotted 43%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	0	0
New York	53,225,000	9,931,300
Philadelphia	0	0
Cleveland	0	0
Richmond	0	0
Atlanta	0	0
Chicago	1,915,000	113,950
St. Louis	0	0
Minneapolis	0	0
Kansas City	0	0
Dallas	0	0
San Francisco	600,000	0
Treasury	0	0
TOTALS	$55,740,000	$10,045,250
Type		
Competitive	$55,740,000	$10,045,250
Noncompetitive	0	0
Subtotal, Public	$55,740,000	$10,045,250
Federal Reserve	0	0
Foreign Official Institutions	0	0
TOTALS	$55,740,000	$10,045,250

LB-484

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

Text as Prepared for Delivery
For Immediate Release
November 5, 1993

TESTIMONY OF TREASURY SECRETARY LLOYD BENTSEN HOUSE FOREIGN AFFAIRS COMMITTEE

I want to tell you that this is not a theoretical exercise for me. I've lived a good many years on the U.S.-Mexican border. I've learned a great deal about Mexico and about trade. I've seen good deals with Mexico, and bad deals. This is a good deal.

It is important that everyone understand that this agreement is not the cause of the problems that make some Americans concerned about NAFTA, but it will solve some of them. This trade agreement didn't pollute the border region, but it will help clean it up. This trade agreement hasn't sent American jobs south, and, in fact, it will create better-paying jobs for Americans. This trade agreement isn't responsible for any unease people may feel about our economy, but it can go a long way toward solving those problems and easing those fears.

Even better, NAFTA will make us more competitive in global markets. And NAFTA is the first step toward solidifying our trading position in Latin America.

For all those reasons, NAFTA is an integral part of our domestic economic agenda, and a key element of our international agenda to create jobs through open markets and trade reciprocity.

Trade is a way of life for us. One in eight U.S. jobs depends directly on trade. That's why I wonder when I hear talk about passing up the chance to increase exports and open markets. I don't know a time when less trade meant more jobs and more prosperity for Americans.

Many of you by now are very familiar with the figures. Since Mexico began dropping its trade barriers, we've seen our position reverse from a trade deficit of nearly $6 billion to a surplus of well over $5 billion. Since 1986 we've picked up 400,000 jobs because of our trade with Mexico. Now some 700,000 Americans depend on trade with Mexico for their livelihood.

Things will get even better with NAFTA. It will create 200,000 more jobs in the next two years alone, and jobs related to exports to Mexico pay about 12 percent above average.

One of the other primary benefits of NAFTA is that it levels out the sharply tilted playing field. With NAFTA, Mexico is dropping tariffs 2 1/2 times what ours are. We're giving up very little, and we're getting quite a lot to achieve the same level of openness.

And these lower tariffs are only for our goods and Canada's, not Japan's or the EC's. But think about what happens if we reject NAFTA. You can bet that Japan and Europe will be banging on the door November 18th. They'll have their order books out.

Where will we be? We'll have retreated behind a wall of protectionism. We'll be losing business.

That's a shame, because Mexicans don't just like American goods, they love American goods. Mexicans buy 70 percent of their imports from us. They buy more manufactured goods from us than Japan. Mexico spends more with us on a per capita basis, than do the more affluent Europeans or Japanese.

We'll also be losing a critical opportunity to become more competitive if we take a pass on NAFTA. It is the challenge of the competition for business in the international market that makes our industries competitive and keeps our productivity up. If you fail to compete, and your productivity suffers, your economy will stagnate.

I don't think there's an American around who wants to see the United States left behind.

As you know, President Clinton wanted to make this agreement better, so the administration negotiated two side agreements, one on labor issues and one on the environment. I want to spend just a minute on those two.

The labor side agreement offers us a precedent-setting way to keep Mexico moving forward in enforcing its labor laws and standards. Many people don't realize that Mexico has good, strong labor laws, but enforcement has been a problem. Mexico has made a commitment to enforce its laws with far stronger actions, and to publish its laws and regulations for all to see.

When people know their rights, and there is a well-publicized commitment to enforce those rights, Mexicans will demand that those rights be observed. And the side agreement's consultation procedures and dispute settlement process in key worker standards, guarantees that we will know of any failure to enforce Mexican labor laws, and we will be able to take meaningful action.

I would remind the committee that without NAFTA, the side agreement won't exist. If we lose NAFTA, we lose this framework to move Mexico forward on the labor front.

Over and above that, on our side, we're phasing in our tariff cuts so that our industries that might feel some impact from NAFTA have time to adjust. We're also committed to a solid package of worker adjustment assistance to make certain that workers who are affected get help.

I know the importance of safe drinking water, adequate wastewater treatment and solid waste disposal. Right now there are hundreds of thousands of households on both sides of the border who lack these basic needs.

We have created a financing mechanism -- at very little out-of-pocket cost to either us of the Mexicans, I might add -- that will take on this problem. We call it the North American Development Bank, or NADBank. Ninety-percent of what it lends will go for environmental projects. The remainder will be available for community adjustment and investment in communities which are affected by NAFTA. I want to emphasize that the NADBank will depend heavily on private sector financing of border projects.

We and the Mexicans will each put in $225 million spread over four years, which will leverage $2 billion to $3 billion in financing. When combined with ongoing financing mechanisms, this approach can help generate the $8 billion estimates suggest will be necessary to clean up the border.

Further, we have provided for an unprecedented level of community involvement in overseeing environmental work.

Finally, let me point out what NAFTA means to us in terms of our global economic strategy. The fact of the matter is that in the international trading arena we compete with Japan and with Europe. Japan and Europe have strategies for capitalizing on regional trade. For instance, the EC is in the final stages of creating a $6.4 trillion market of nearly 350 million people. The United States is in a unique position because we can be both an Atlantic and a Pacific trading partner. We have to compete everywhere. But like the EC and Europe, we must have a strategy for our own backyard.

Let me give you an example of how Japan has benefitted from having a regional strategy. For some time now, Japan has been working on increasing its trade with its closest neighbors. That's a smart move. Asia has the fastest growing economies in the world. Why not trade with your closest neighbors? They've turned a market that was $25 billion or $30 billion two decades ago into a market worth as much as $150 billion to them. They and China have the edge in Asia. No question about it.

But look at Latin America. It's the second-fastest growing region in the world, and it's right next door to us. Already 700,000 Americans have jobs that depend on trade with just Mexico alone. I mentioned how much Mexico loves our products. In fact, they've replaced Japan as our second-largest customer of manufactured goods.

The market in Latin America is growing, and NAFTA will help us unlock the potential. Just as Japan does well in Asia, we ought to be doing everything we can to solidify our position in these markets. We shouldn't leave these markets to our competition.

If we pass NAFTA, we get jobs, trade and a stronger, more competitive economy. If we fail to pass it, if we fall prey to fears I'm absolutely convinced will never materialize, not only do we lose NAFTA, we also jeopardize the GATT negotiations, and we deny ourselves the chance to continue leading the way in the Latin American market.

One final point. I saw a study from a very respected independent economic forecasting firm, [Wharton WEFA] the other day about what happens if we don't pass NAFTA. It had some figures that caught my eye. It said that if we don't pass NAFTA, a decade from now total employment will be half a million lower than what it could be, that manufacturing jobs would be 170,000 lower than what it could be, and that our GDP will be $43 billion lower, and that works out to $330 per year less for the average working America.

Mr. Chairman, the choice is clear to me. Thank you.

-30-

TALKING POINTS
FOR THE
FINANCING PRESS CONFERENCE

November 3, 1993

Today, we are announcing the terms of the regular Treasury November midquarter refunding. I will also discuss Treasury financing requirements for the balance of the current calendar quarter and our estimated cash needs for the January-March 1994 quarter.

1. We are offering $29.0 billion of notes and $14.0 billion of cash management bills to refund $32.2 billion of privately held notes and bonds maturing on November 15 and to raise approximately $10.8 billion of cash.

The three securities are:

-- First, a 3-year note in the amount of $17.0 billion, maturing on November 15, 1996. This note is scheduled to be auctioned on a yield basis at 1:00 p.m. Eastern time on Tuesday, November 9, 1993. The minimum purchase amount will be $5,000 and purchases above $5,000 may be made in multiples of $1,000.

-- Second, a 9 3/4-year note in the amount of $12.0 billion, which is a reopening of the 5 3/4 percent note maturing on August 15, 2003. This note is scheduled to be auctioned on a yield basis at 1:00 p.m. Eastern time on Wednesday, November 10. The minimum purchase amount will be $1,000.

-- Third, a 66-day cash management bill in the amount of $14.0 billion, maturing on January 20, 1994. This bill is scheduled to be auctioned on a discount rate basis at 11:30 a.m. Eastern time on Tuesday, November 9, 1993. The minimum purchase amount will be $10,000 and purchases above $10,000 may be in multiples of $1,000.

2. As announced on Monday, November 1, 1993, we estimate a net market borrowing need of $85.2 billion for the October-December quarter. The estimate assumes a $35 billion cash balance at the end of December. Including this refunding, we will have raised a net $47.1 billion of the $85.2 billion in market borrowing needed this quarter. This net cash from borrowing was accomplished as follows:

-- $3.3 billion from the 2-year note that settled on November 1;

-- $12.3 billion from the 5-year note that settled on November 1;

-- $16.1 billion from the regular weekly bills including those announced yesterday;

-- $1.6 billion from the 52-week bill that settled on October 21;

-- $10.0 billion from the cash management bill that settles on November 10;

-- $14.0 billion from the cash management bill that settles on November 15;

-- a paydown of $7.0 billion in the 7-year note that matured on October 15; and

-- paydowns totaling $3.2 billion of the notes and bonds that mature on November 15.

The Treasury will need to raise $38.1 billion in market borrowing during the rest of the October-December quarter. This financing could be accomplished through regular sales of 13-, 26-, and 52-week bills and 2-year and 5-year notes. Another short-term cash management bill may be necessary to cover a cash low-point in early December.

3. We estimate Treasury net market borrowing needs to be in the range of $60 billion to $65 billion for the January-March 1994 quarter, assuming a $20 billion cash balance on March 31.

4. We will accept noncompetitive tenders up to $5 million for each of the notes and up to $1 million for the cash management bill. The 9 3/4-year notes being announced today are eligible for conversion to STRIPS (Separate Trading of Registered Interest and Principal of Securities) and, accordingly, may be divided into separate interest and principal components.

5. We are also announcing that, beginning with the November midquarter refunding auctions, the Treasury will

discontinue announcing the results of Treasury auctions on a regional or Federal Reserve District basis.

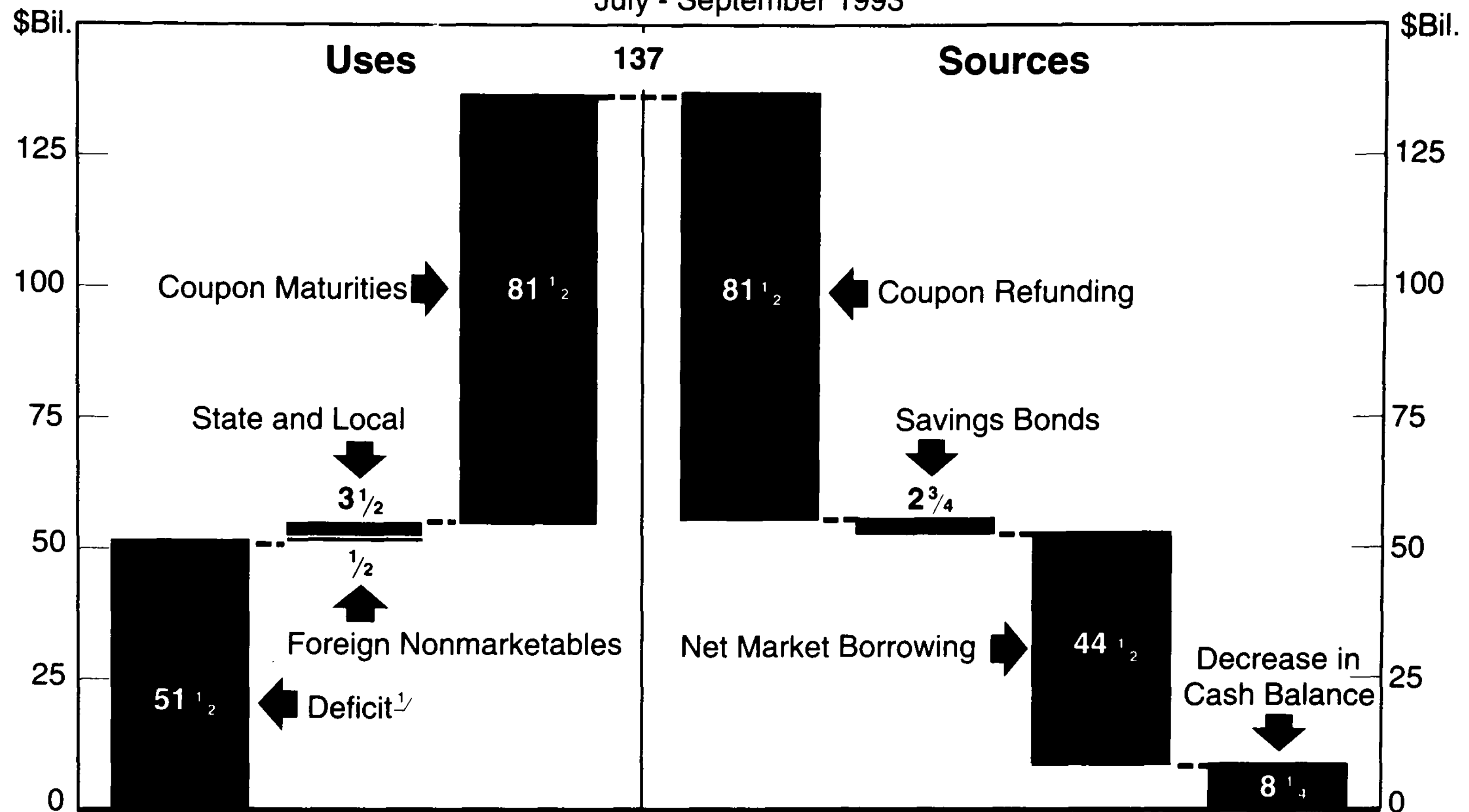
This change in procedure is being made, because regional auction award information has little value in the worldwide U.S. Government securities market. It will also eliminate a step in processing auction award information for release to the public, and it may, therefore, have a slight benefit in shortening the time between the deadline for the receipt of tenders and the announcement of the auction results.

6. I want to call your attention to the calendars that are included in the chart package that we have distributed. To accommodate Thanksgiving, we will auction the November 2-year note at 11:30 a.m. Eastern time on Monday, November 22 and the 5-year note at 1:00 p.m. on Tuesday, November 23. Weekly bills will be sold at their usual time, 1:00 p.m. Eastern time, on Monday. The December 2- and 5-year notes are scheduled to be auctioned on December 21 and 22 for settlement on December 31.

7. The February midquarter refunding press conference will be held on Wednesday, February 2, 1994.

TREASURY FINANCING REQUIREMENTS

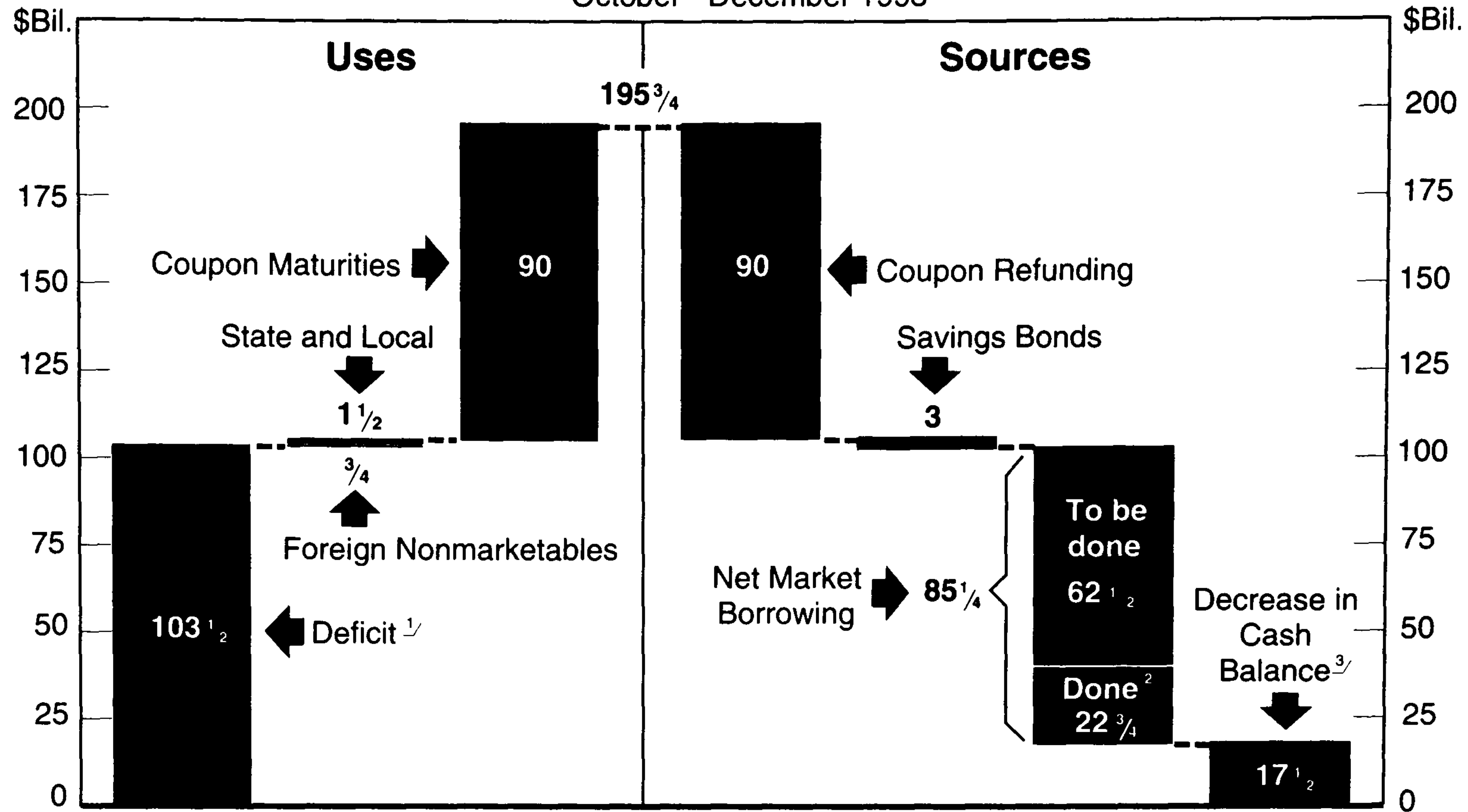
July - September 1993



1/ Includes budget deficit, changes in accrued interest and checks outstanding and minor miscellaneous debt transactions.

TREASURY FINANCING REQUIREMENTS

October - December 1993



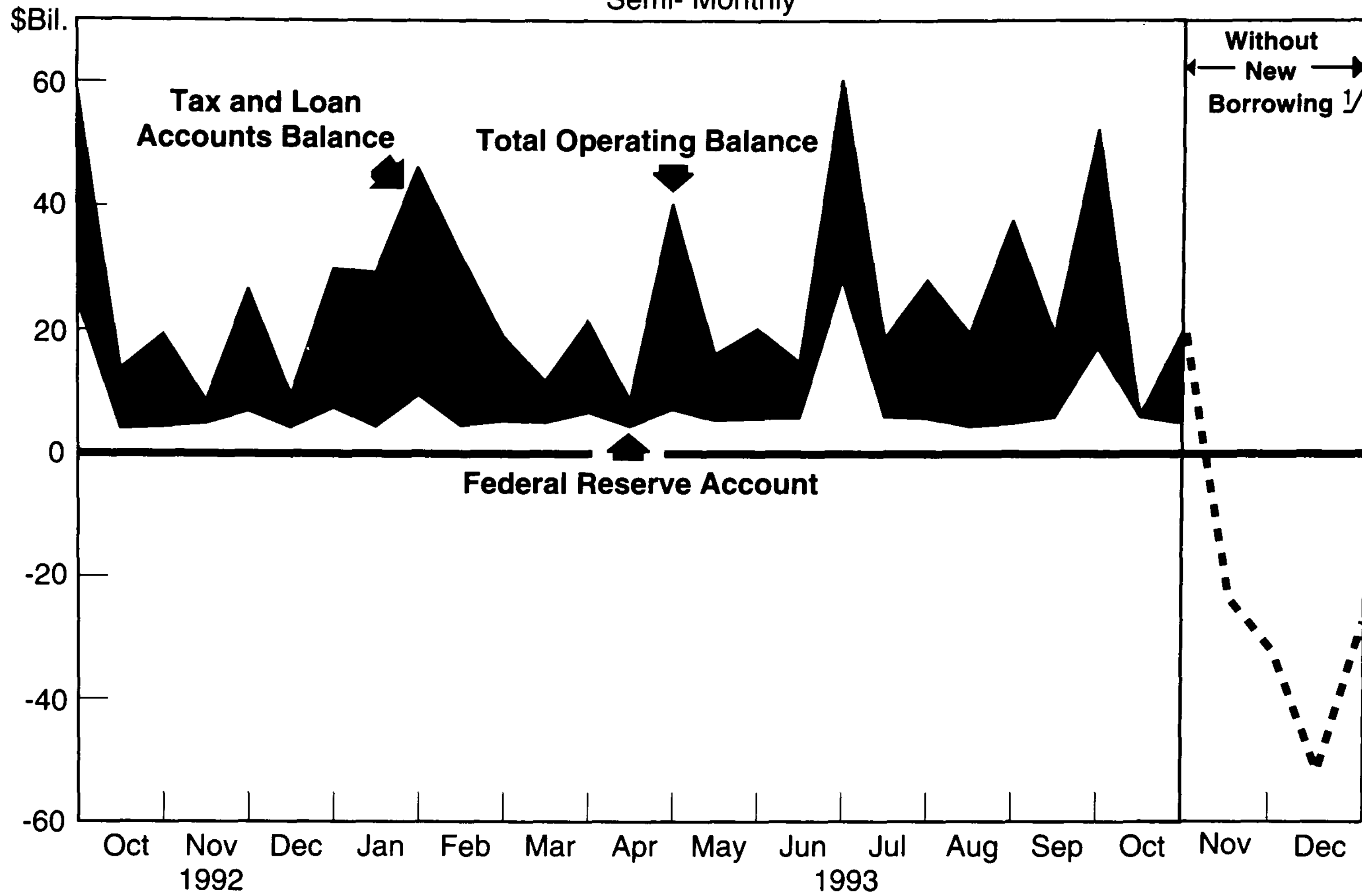
1/ Includes budget deficit, changes in accrued interest and checks outstanding and minor miscellaneous debt transactions.

2/ Issued or announced through October 29, 1993.

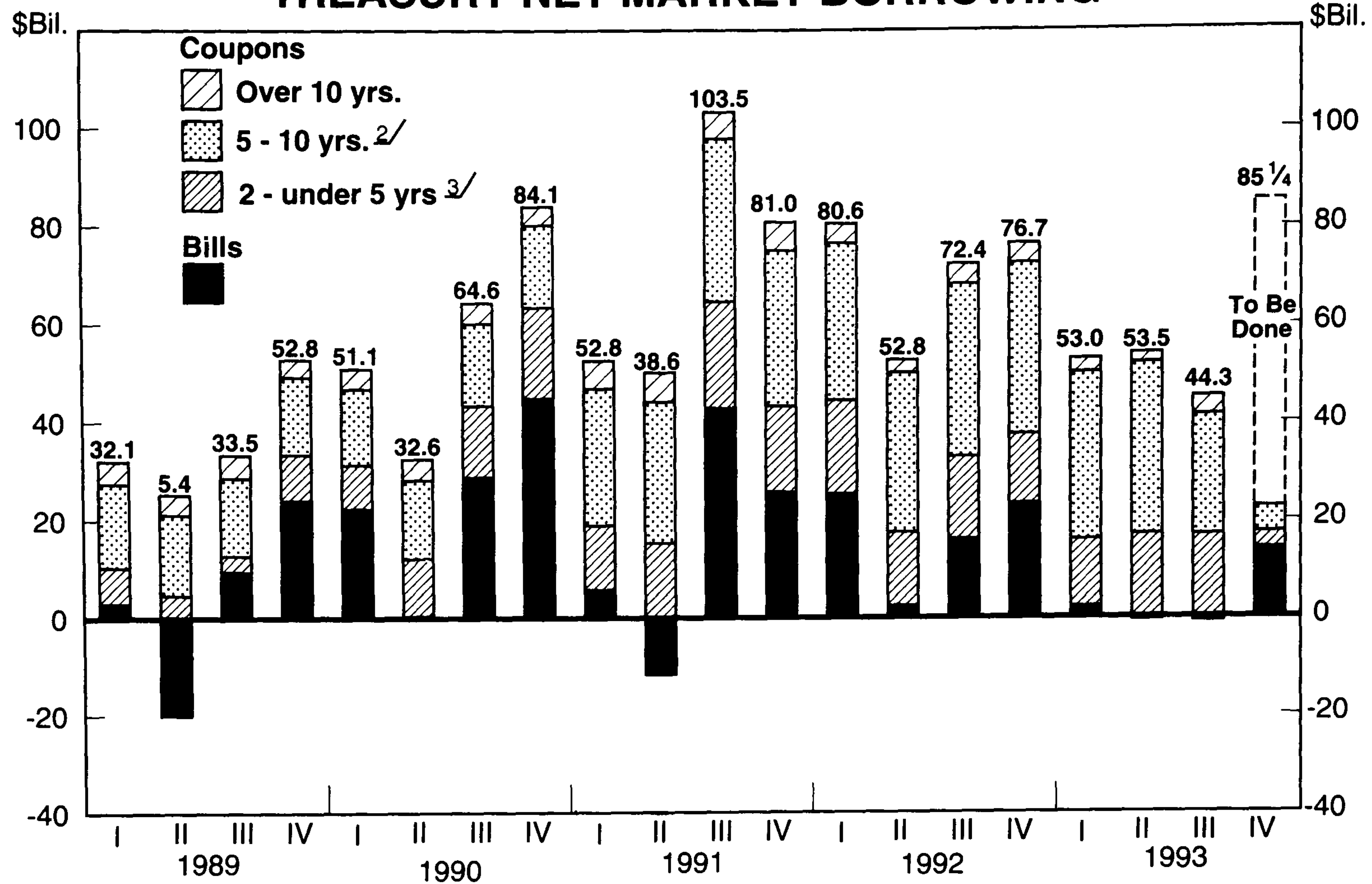
3/ Assumes a $35 billion cash balance December 31, 1993.

Department of the Treasury
Office of Market Finance

November 1, 1993-18

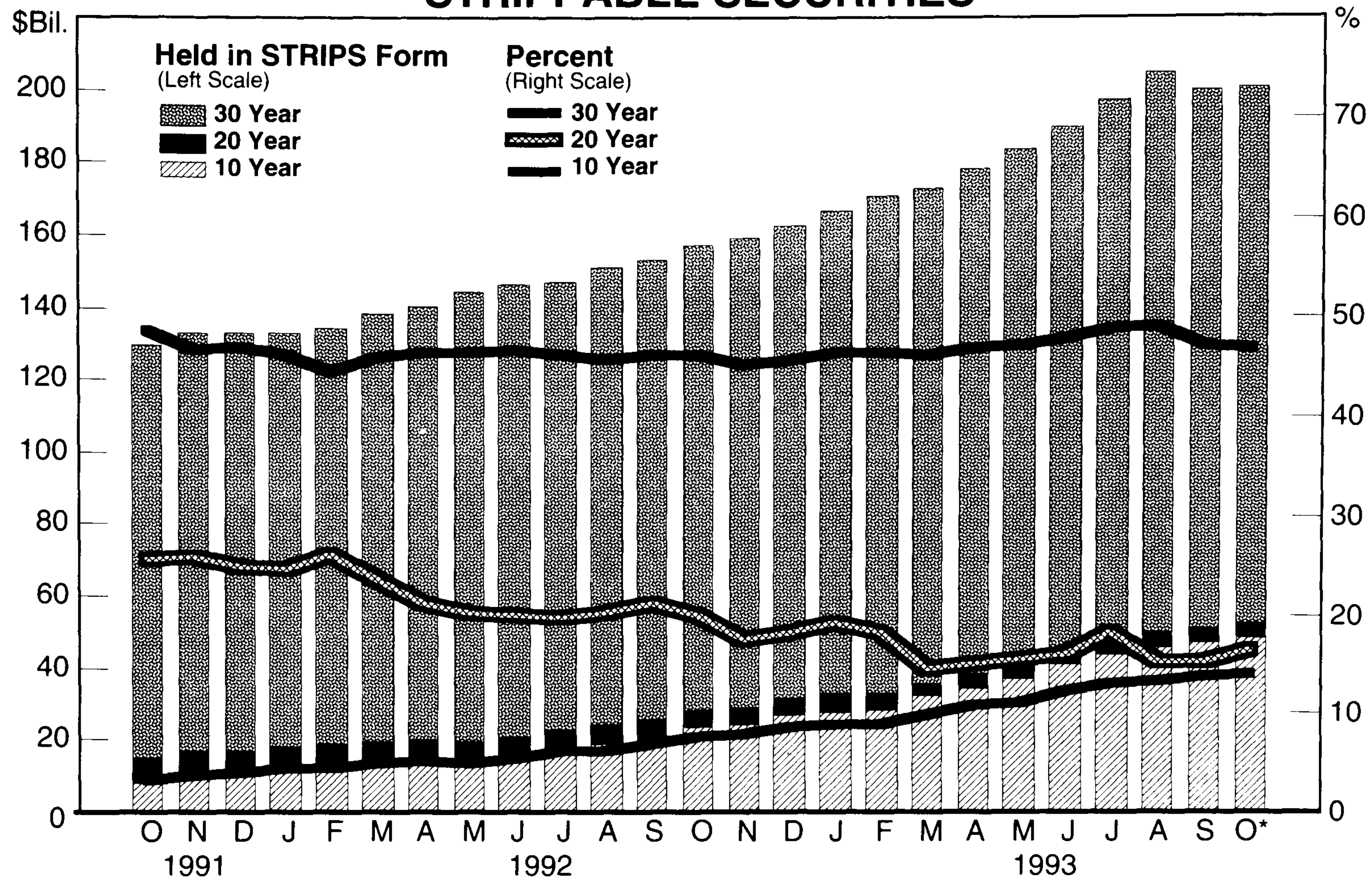


1/ Assumes refunding of maturing issues.



1/ Excludes Federal Reserve and Government Account Transactions.
2/ 7 year note discontinued after April 1993.
3/ 4 year note discontinued after December 1990.

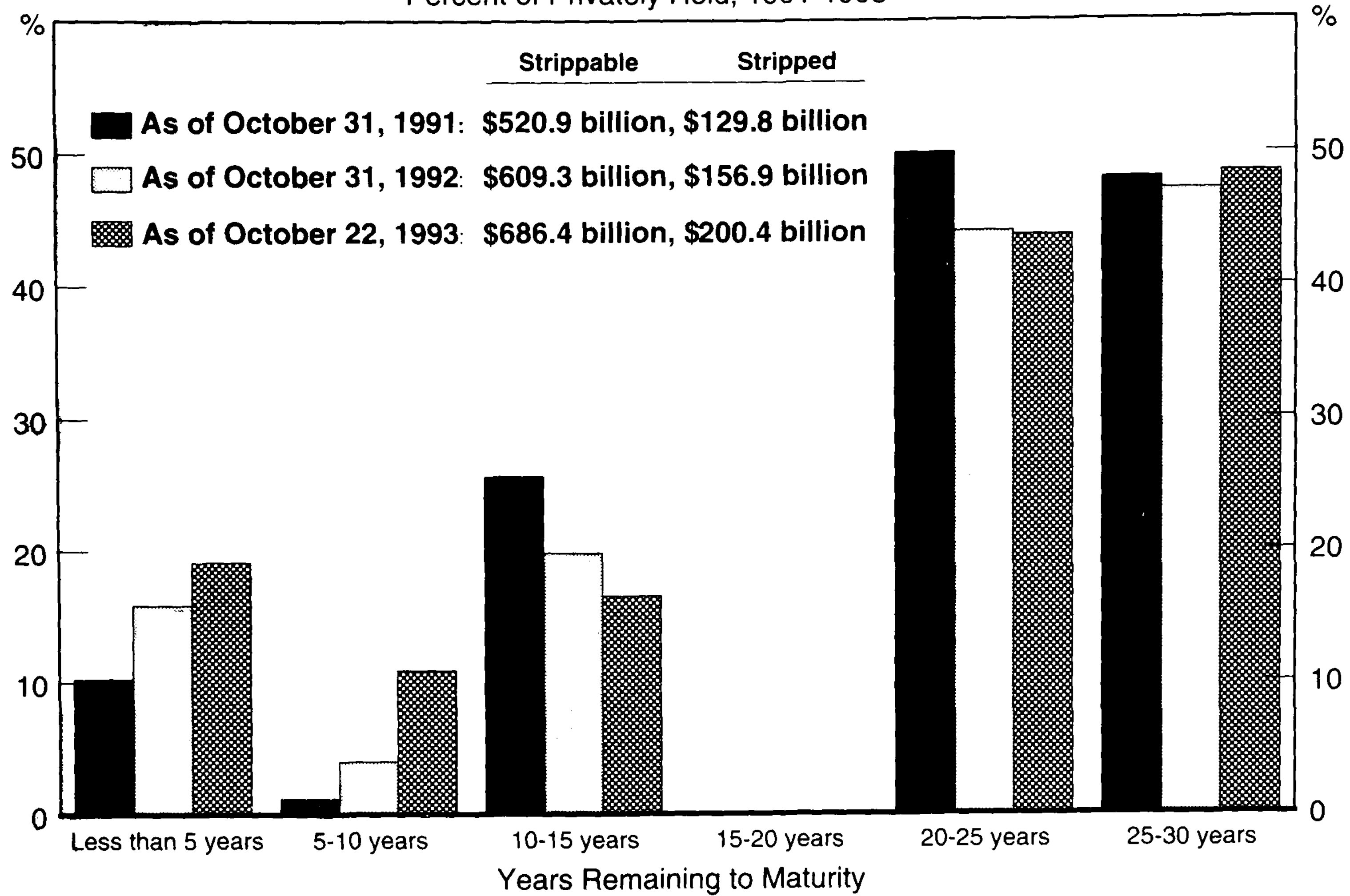
Department of the Treasury
Office of Market Finance



*Through October 22, 1993
By period to maturity on original issue.

Department of the Treasury
Office of Market Finance

November 1, 1993-12

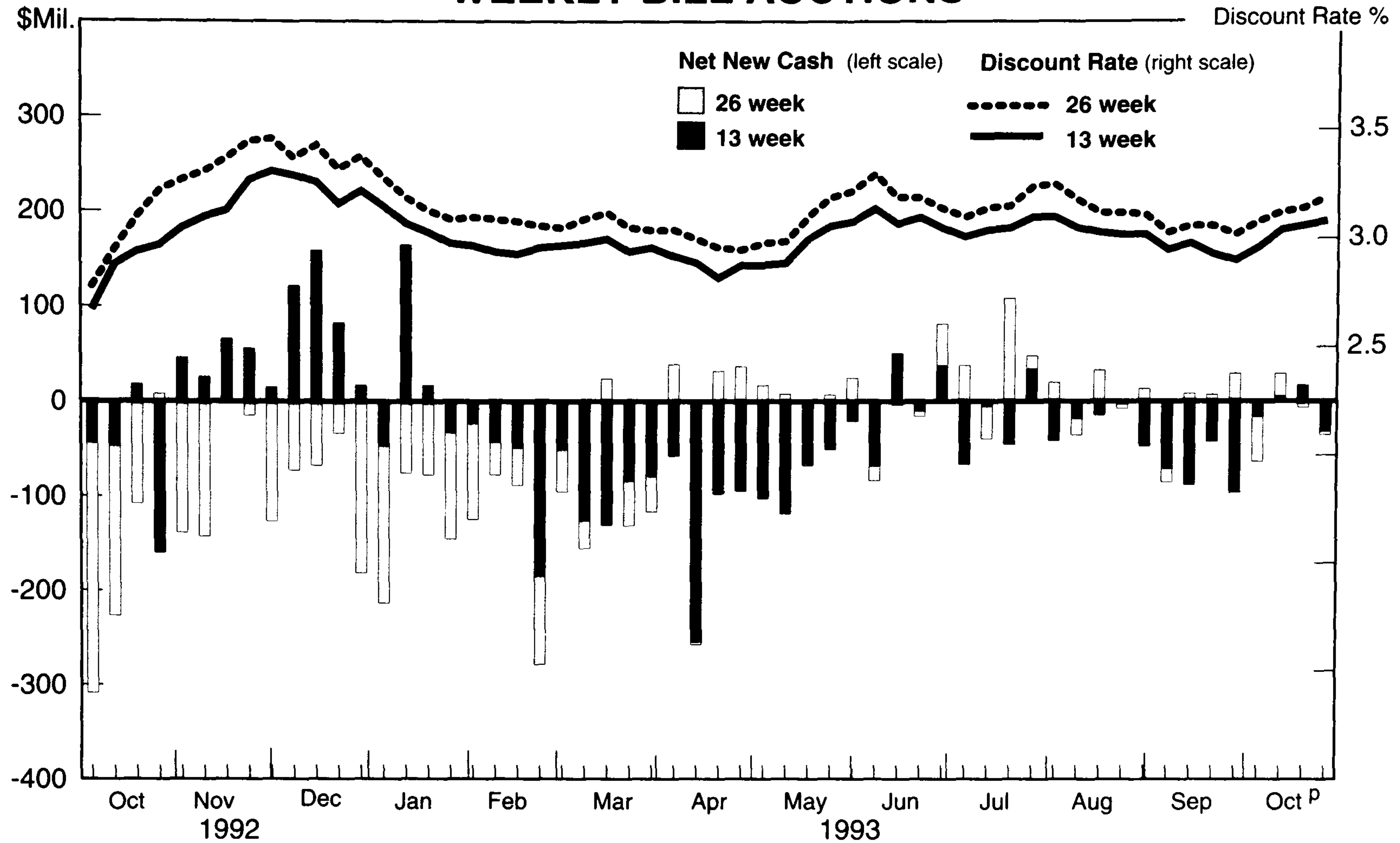


Note: The STRIPS program was announced January 15, 1985.

Department of the Treasury
Office of Market Finance

November 1, 1993-16

NET NEW CASH FROM NONCOMPETITIVE TENDERS IN WEEKLY BILL AUCTIONS [1]



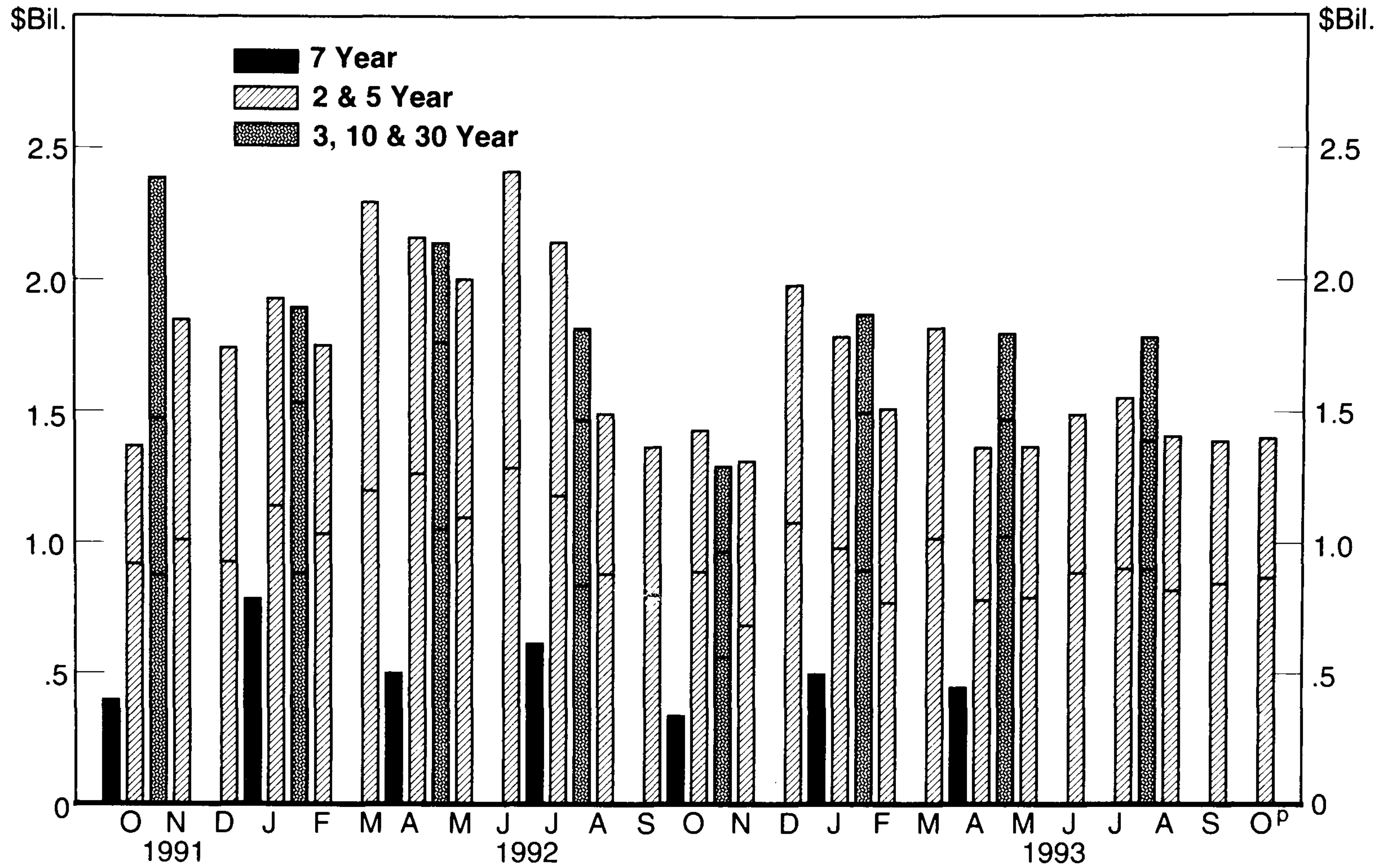
1/ Excludes noncompetitive tenders from foreign official accounts and the Federal Reserve account.

p Preliminary

Department of the Treasury
Office of Market Finance

November 1, 1993-14

NONCOMPETITIVE TENDERS IN TREASURY NOTES AND BONDS [1]



1/ Excludes foreign add-ons from noncompetitive tenders.

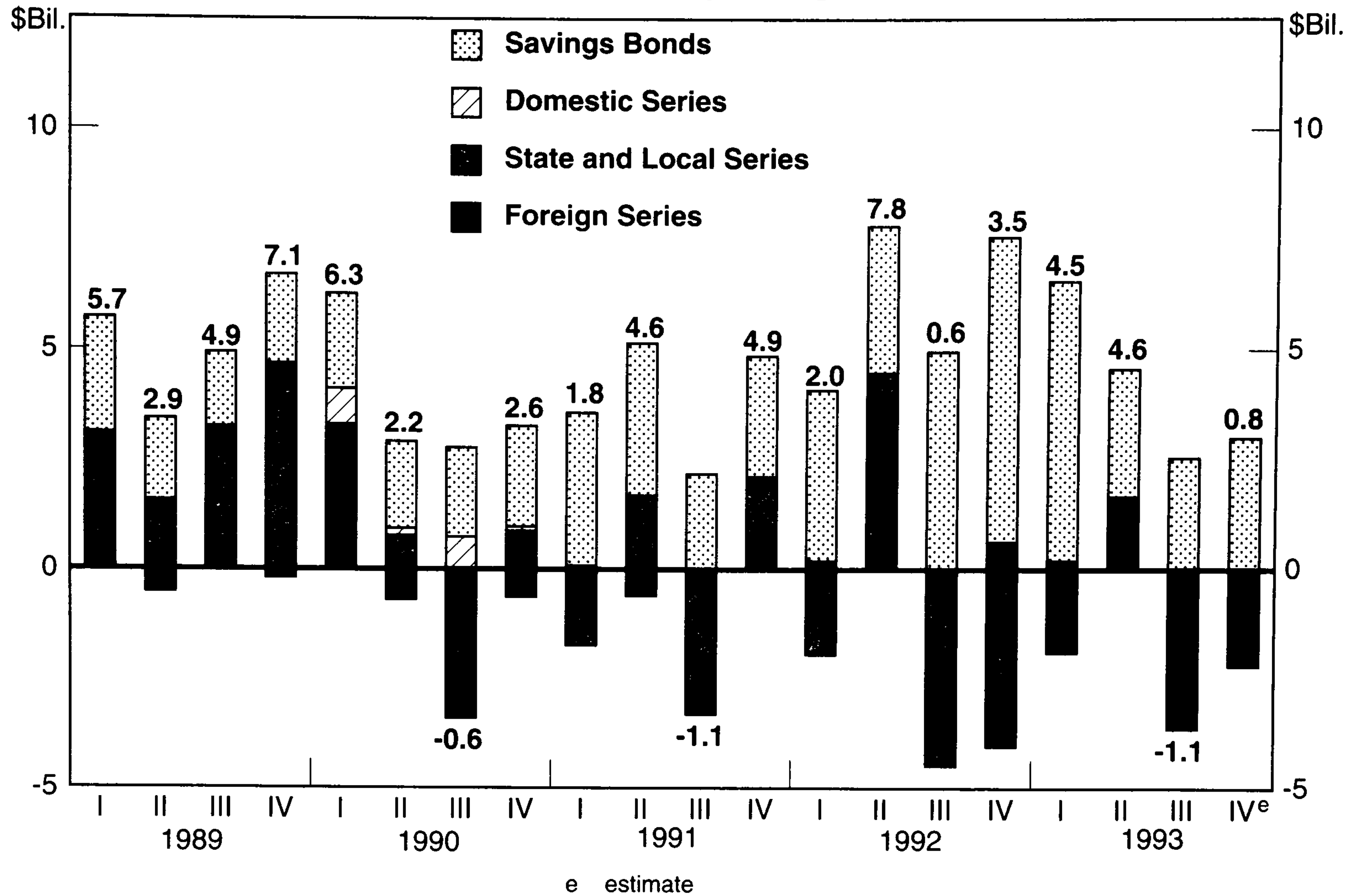
p Preliminary

Treasury increased the maximum noncompetitive award to any noncompetitive bidder to $5 million effective November 5, 1991.

Effective February 11, 1992 a noncompetitive bidder may not hold a position in WI trading, futures, or forward contracts, nor submit both competitive and noncompetitive bids for its own account.

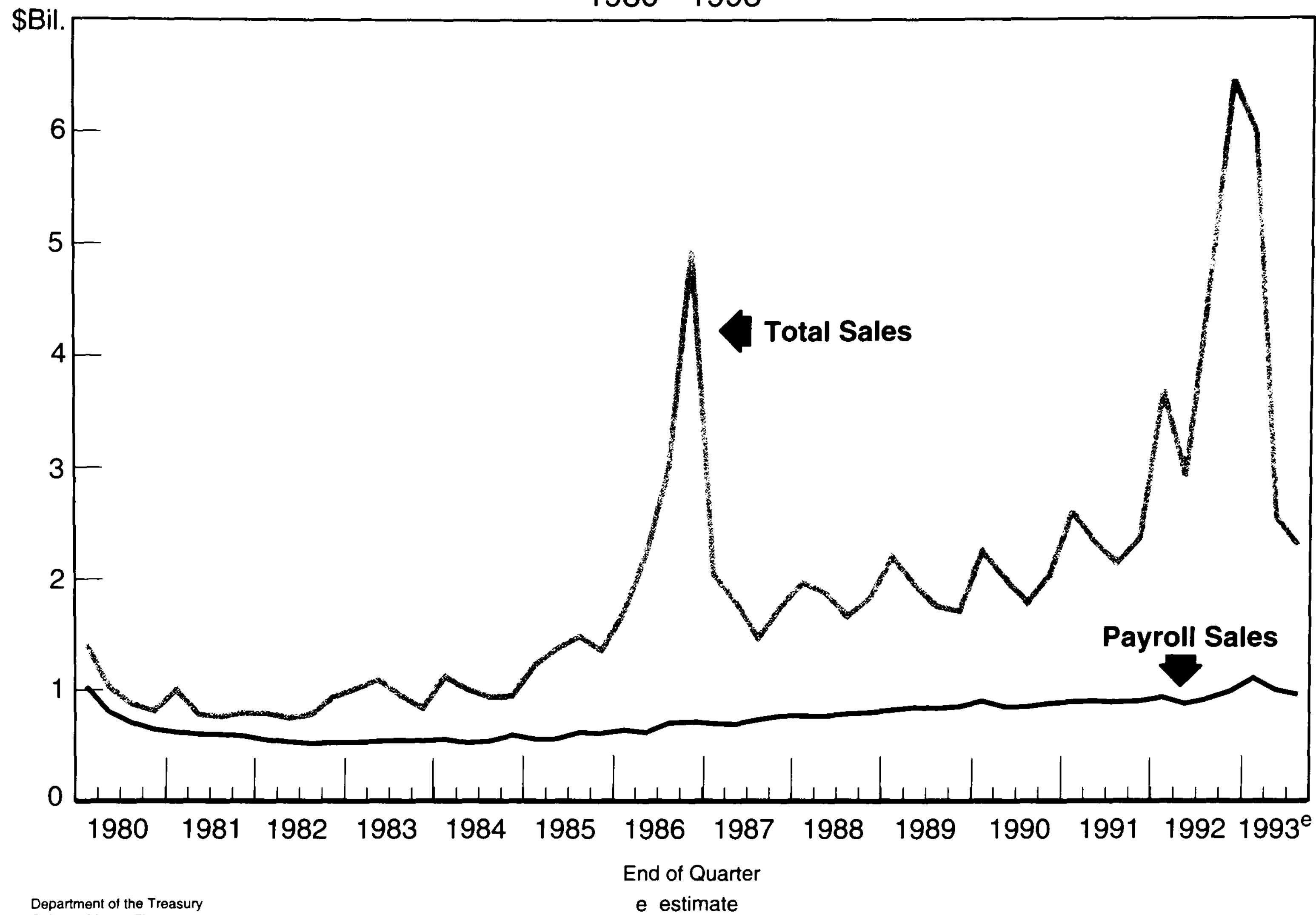
Department of the Treasury
Office of Market Finance

November 1, 1993-13



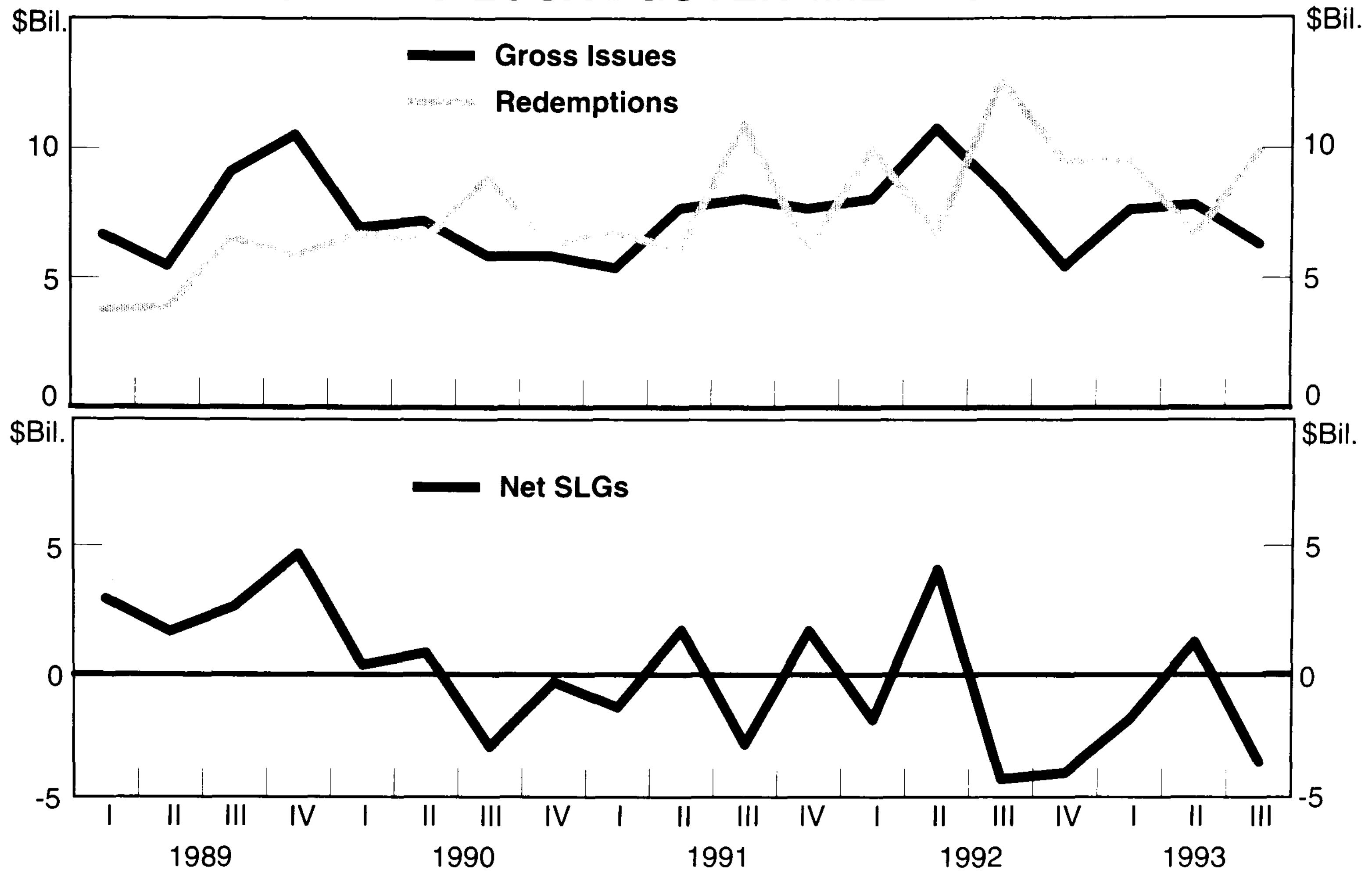
Department of the Treasury
Office of Market Finance

November 1, 1993-29



Department of the Treasury
Office of Market Finance

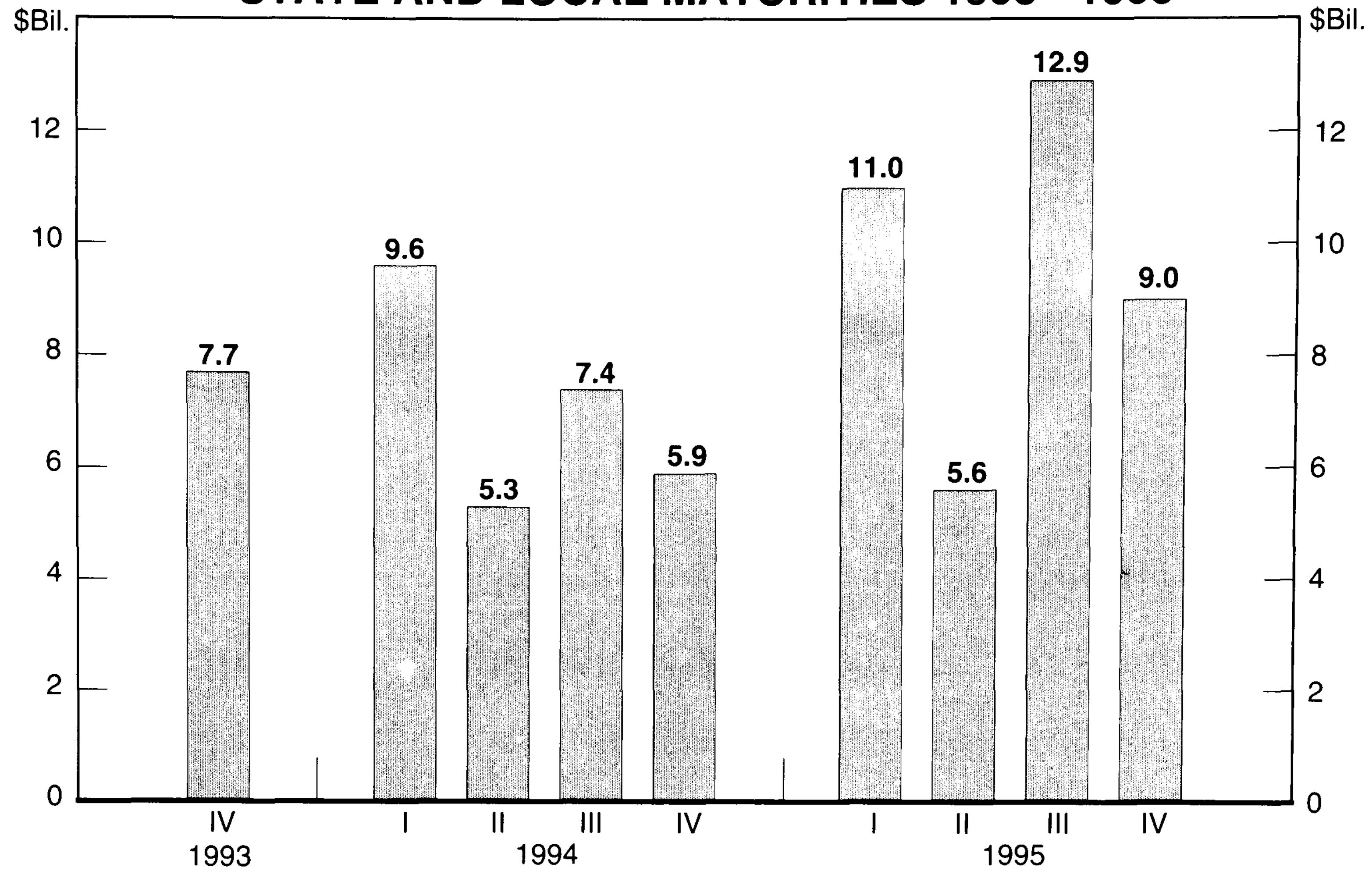
November 1, 1993-15



Department of the Treasury
Office of Market Finance

November 1, 1993-27

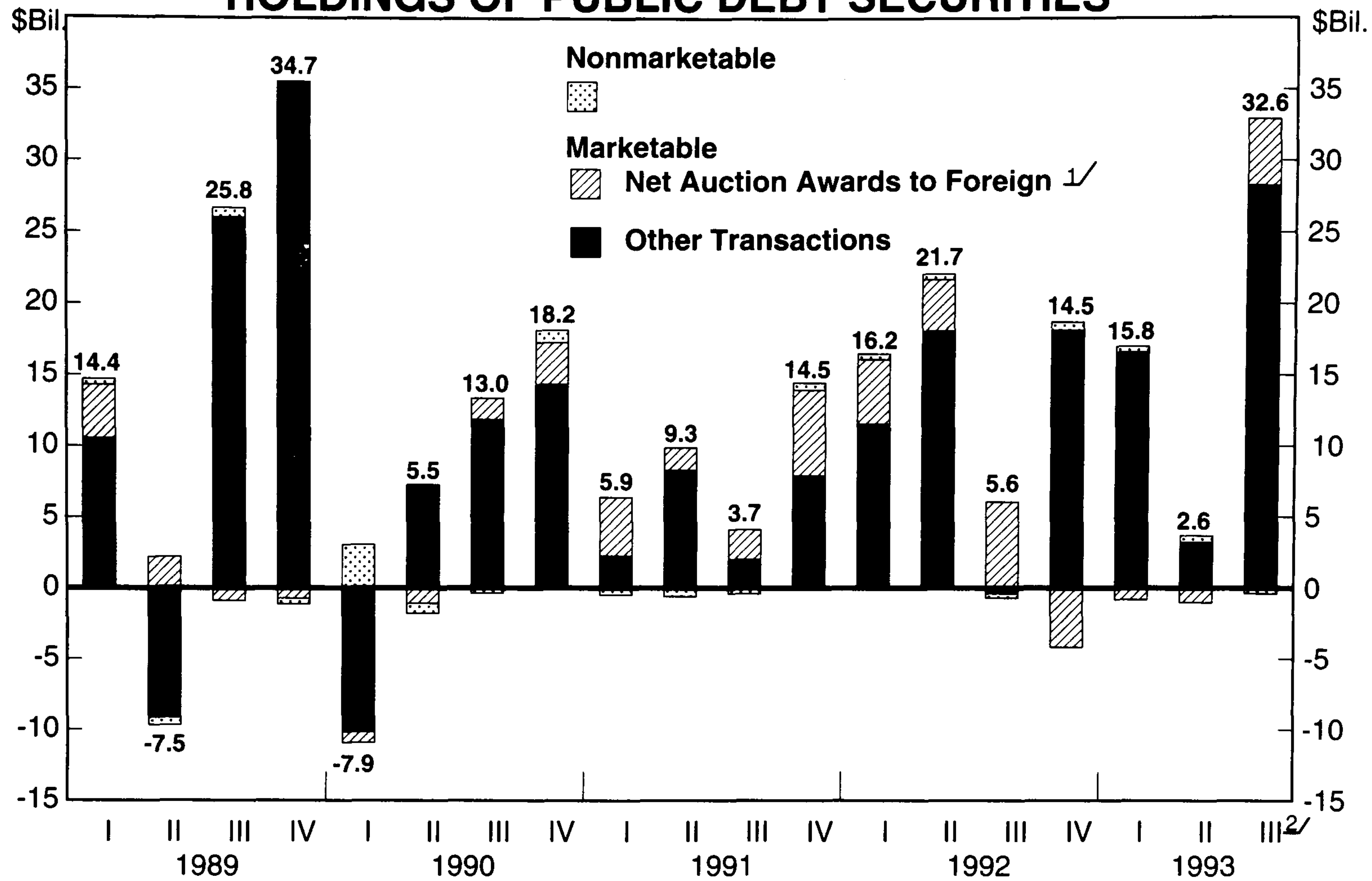
STATE AND LOCAL MATURITIES 1993 - 1995



Department of the Treasury
Office of Market Finance

November 1, 1993-26

QUARTERLY CHANGES IN FOREIGN AND INTERNATIONAL HOLDINGS OF PUBLIC DEBT SECURITIES



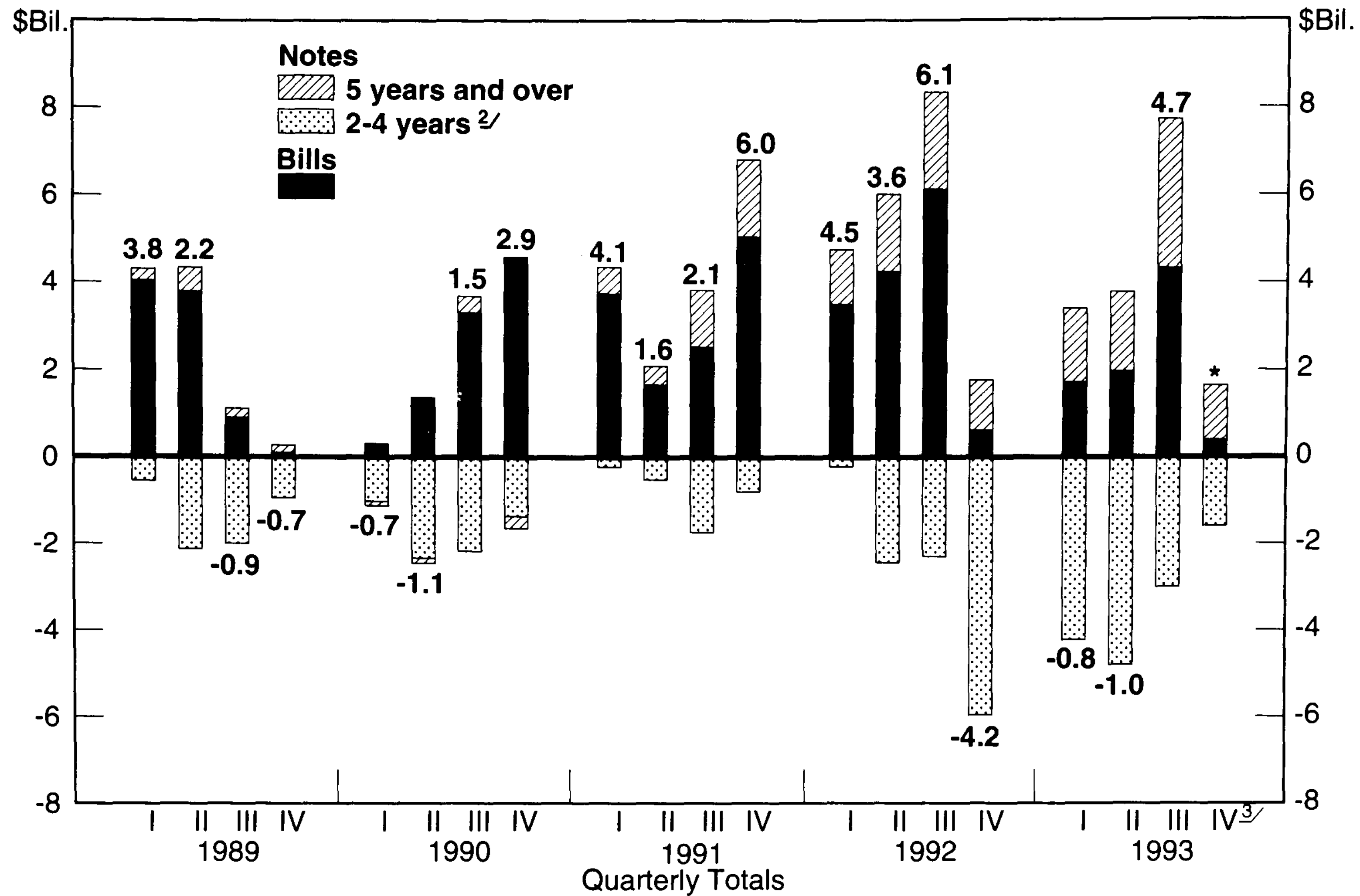
1/ Auction awards to foreign custody purchasers netted against holdings of maturing securities.

2/ Preliminary

Department of the Treasury
Office of Market Finance

November 1, 1993-24

NET AWARDS TO FOREIGN OFFICIAL ACCOUNTS 1/



1/ Noncompetitive awards to foreign official accounts held in custody at the Federal Reserve in excess of foreign custody account holdings of maturing securities.

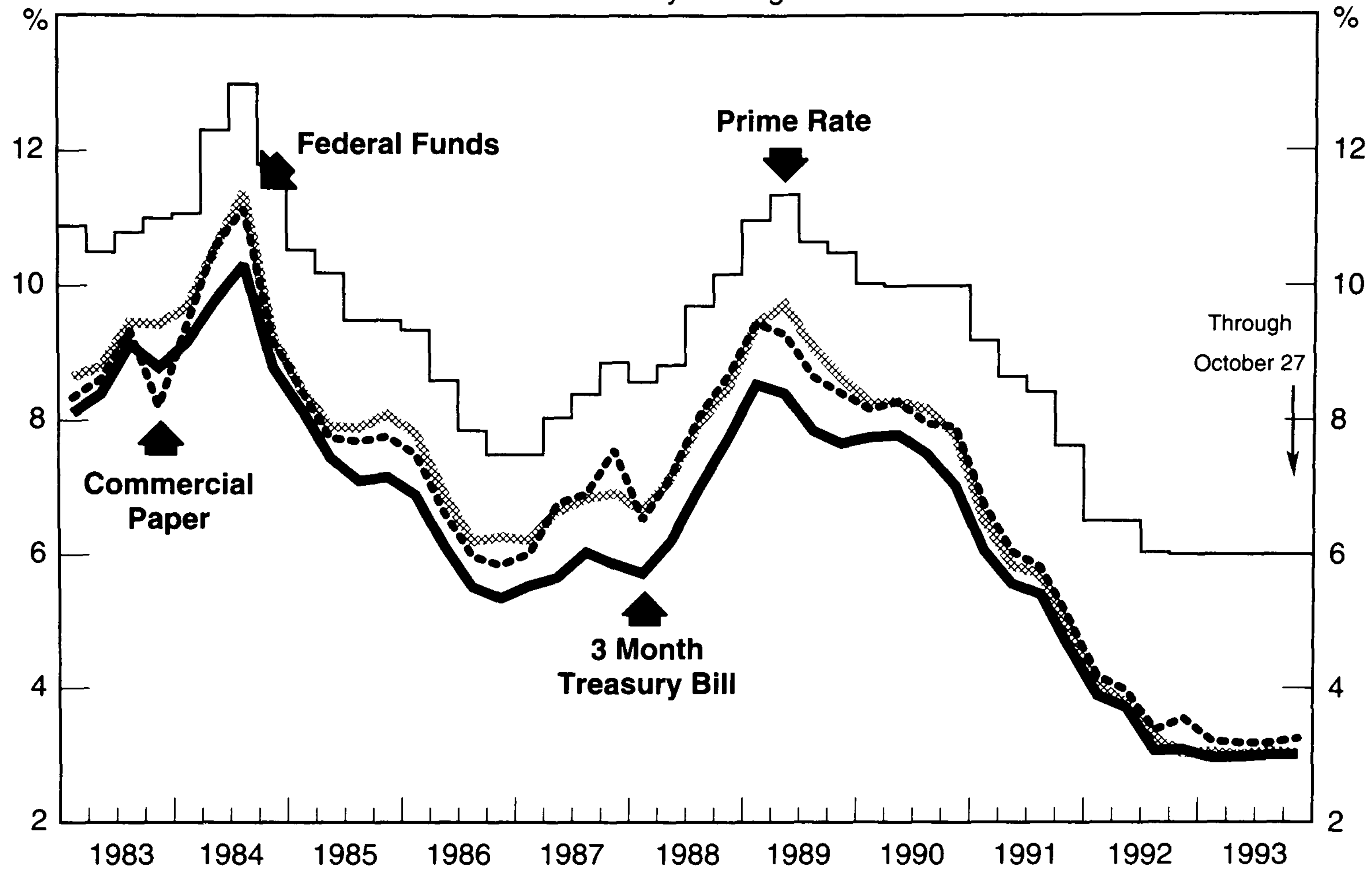
2/ 4 year notes not issued after December 31, 1990.

3/ Through October 29, 1993.

* Less than $50 million.

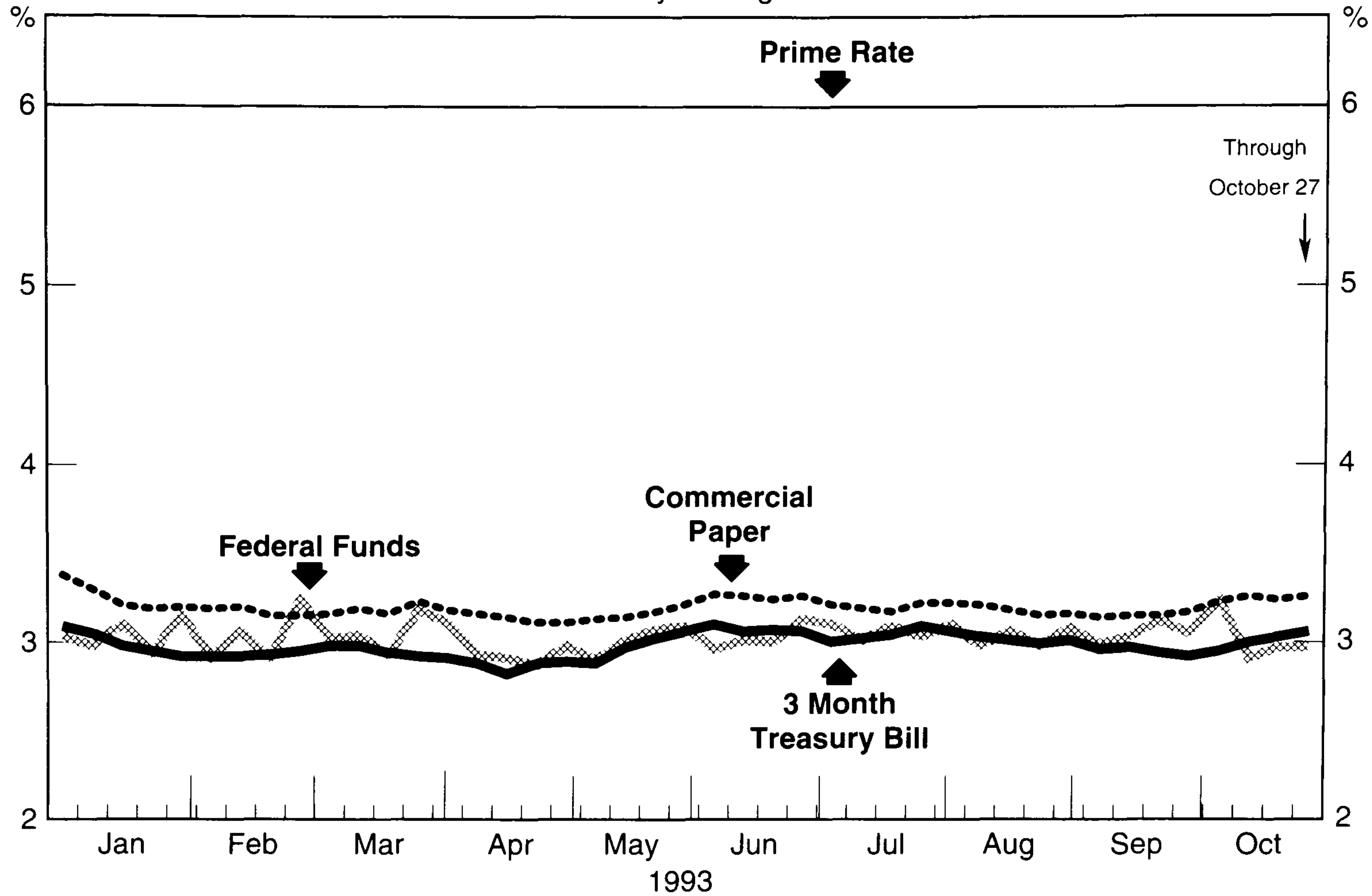
Department of the Treasury
Office of Market Finance

November 1, 1993-25



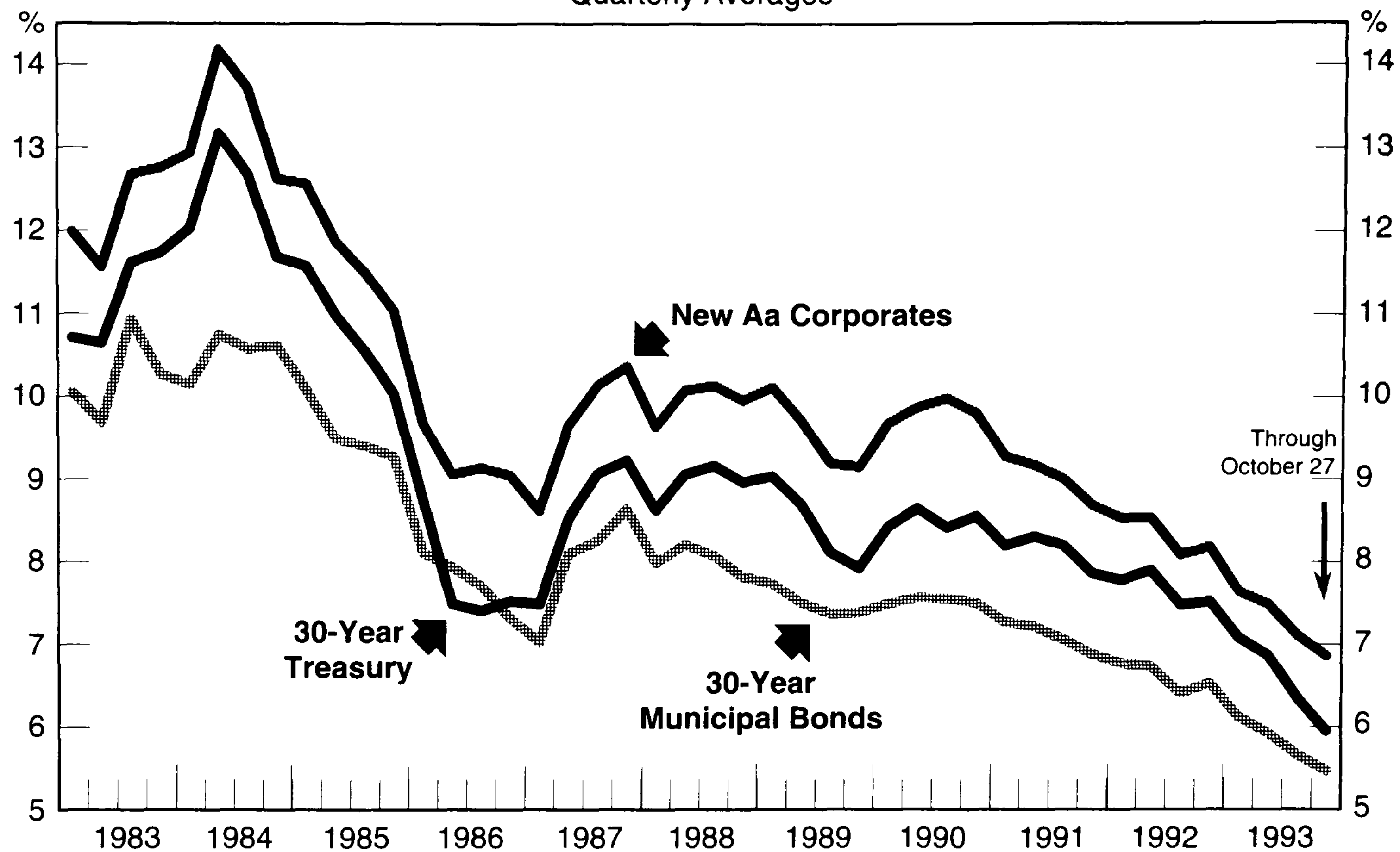
Department of the Treasury
Office of Market Finance

November 1, 1993-22



Department of the Treasury
Office of Market Finance

November 1, 1993-23

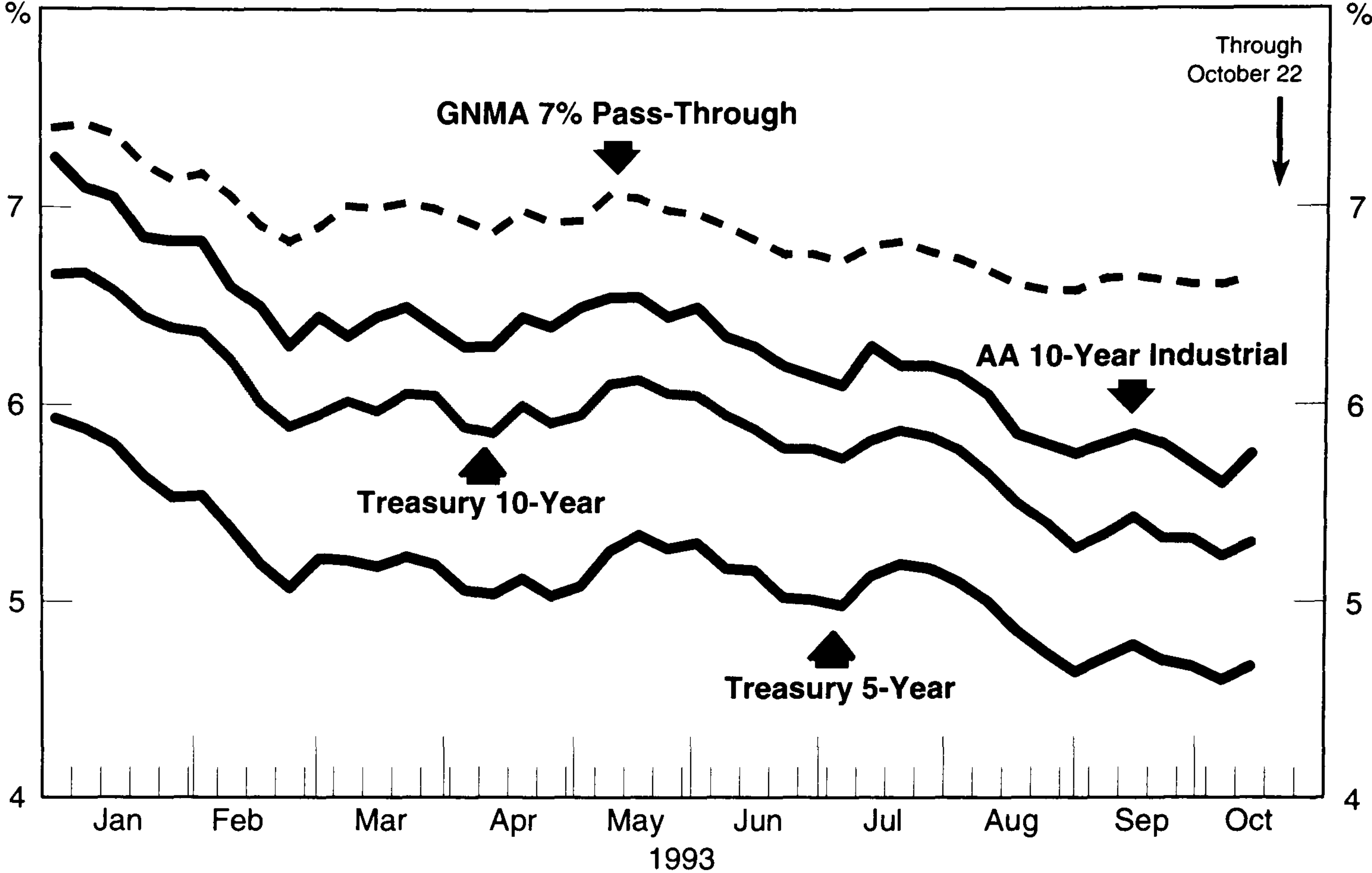


Department of the Treasury
Office of Market Finance

November 1, 1993-20

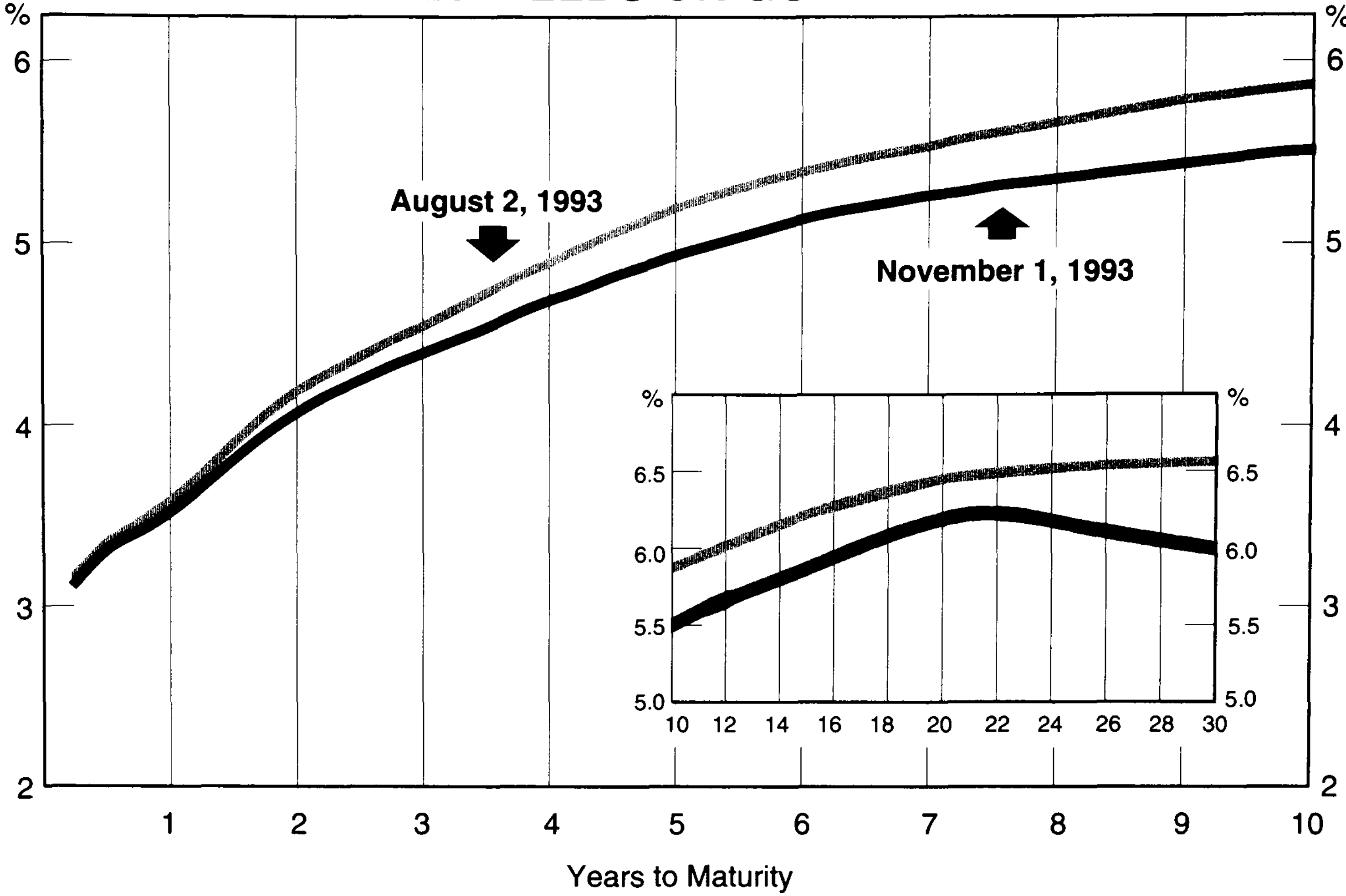
INTERMEDIATE TERM INTEREST RATES

Weekly Averages*



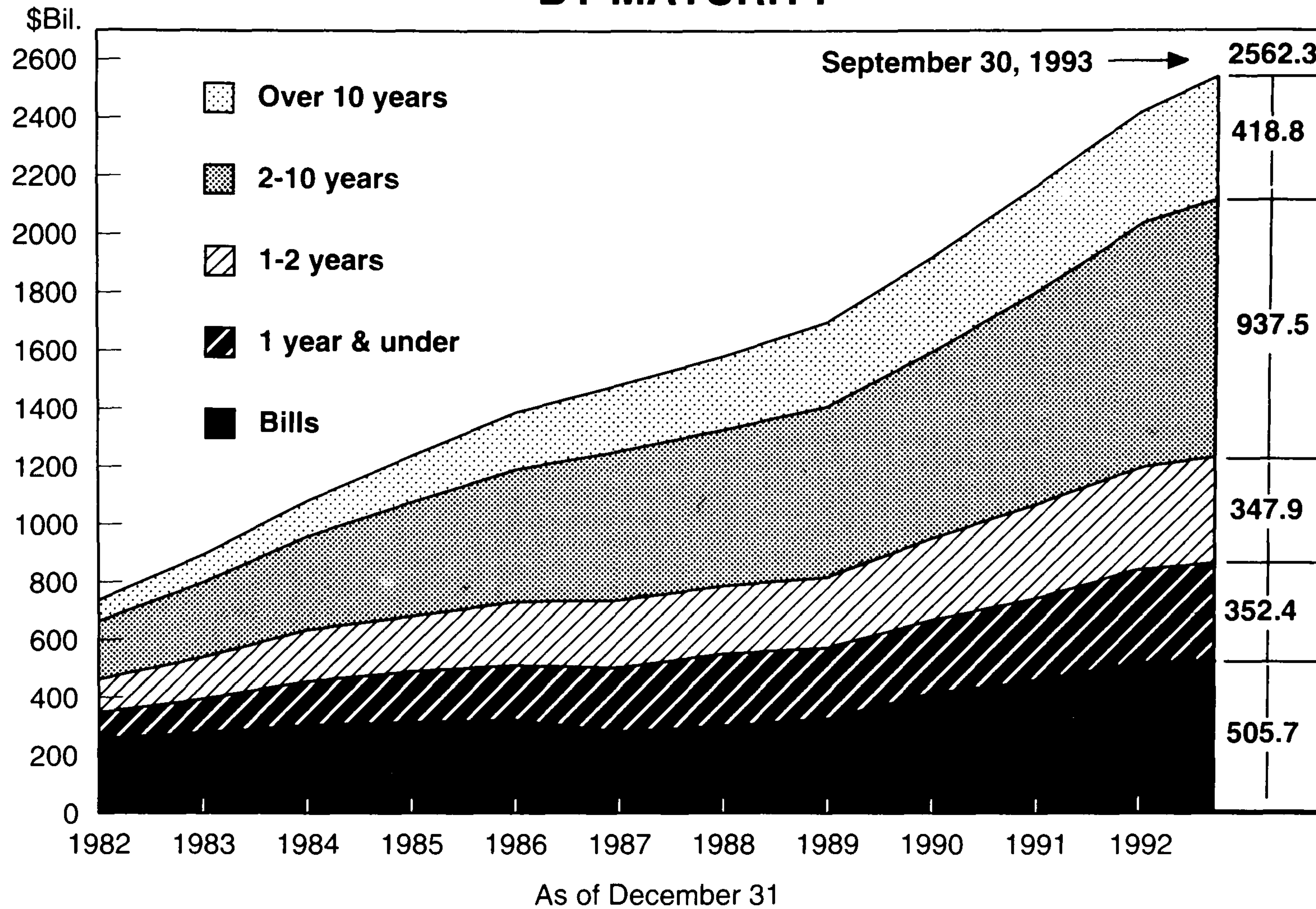
* Salomon 10-yr. AA Industrial is a Thursday rate. All rates are offer side.

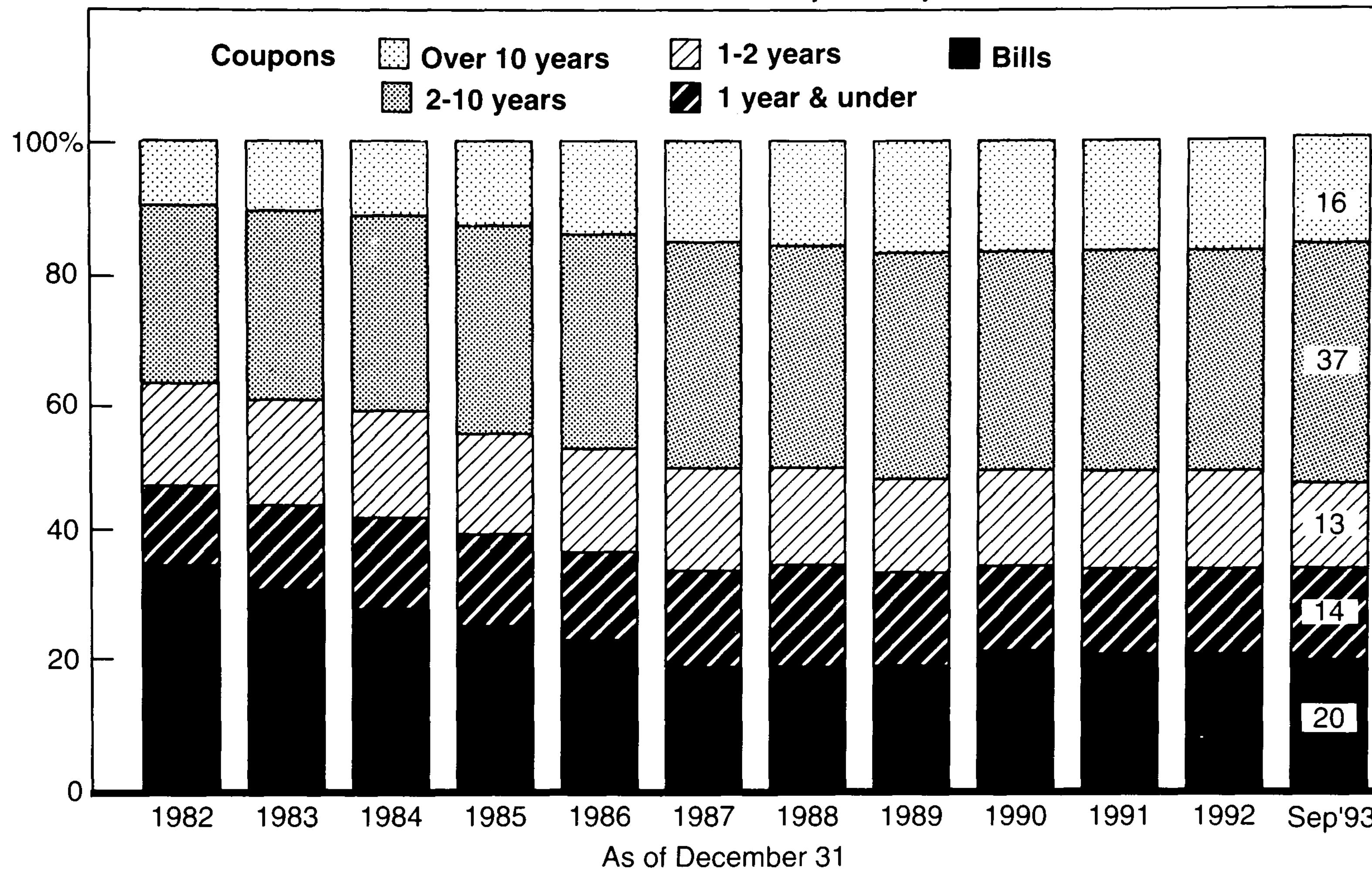
Department of the Treasury
Office of Market Finance



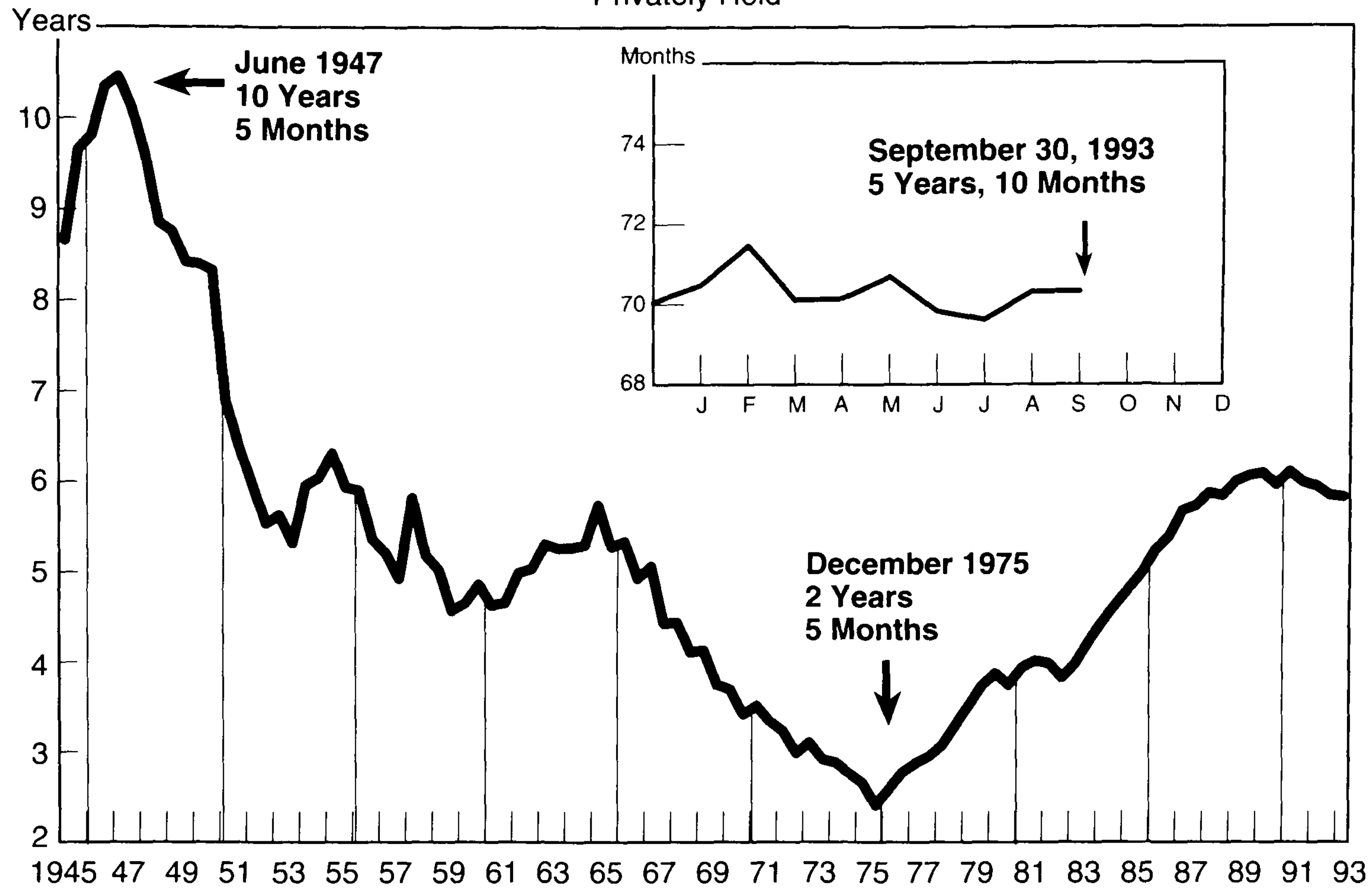
Department of the Treasury
Office of Market Finance

PRIVATE HOLDINGS OF TREASURY MARKETABLE DEBT BY MATURITY





PRIVATE HOLDINGS OF TREASURY MARKETABLE DEBT
Percent Distribution By Maturity
Coupons
Over 10 years
2-10 years
1-2 years
1 year & under
Bills
100%
80
60
40
20
0
16
37
13
14
20
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
Sep'93
As of December 31
Department of the Treasury
Office of Market Finance
November 1, 1993-2



Department of the Treasury
Office of Market Finance

November 1, 1993-3

MATURING COUPON ISSUES

November 1993 - March 1994

(in millions of dollars)

Maturing Coupons			September 30, 1993			
			Total	Held by		
				Federal Reserve & Government Accounts	Private Investors	Foreign[1] Investors
11 3/4%	Note	11/15/93	12,478	2,223	10,255	1,078
9 %	Note	11/15/93	7,518	272	7,246	426
7 3/4%	Note	11/15/93	17,211	3,776	13,435	1,356
8 5/8%	Bond	11/15/93	1,509	224	1,285	35
5 1/2%	Note	11/30/93	15,629	1,146	14,483	1,359
7 5/8%	Note	12/31/93	8,974	778	8,196	452
5 %	Note	12/31/93	16,539	2,133	14,406	1,426
7 %	Note	1/15/94	7,295	616	6,679	566
4 7/8%	Note	1/31/94	15,132	639	14,493	717
8 7/8%	Note	2/15/94	7,806	225	7,581	1,282
6 7/8%	Note	2/15/94	15,557	1,867	13,690	1,839
9 %	Bond	2/15/94	3,010	176	2,834	231
5 3/8%	Note	2/28/94	15,952	763	15,189	1,038
8 1/2%	Note	3/31/94	9,220	1,055	8,165	1,126
5 3/4%	Note	3/31/94	17,817	2,550	15,267	1,309
Totals			171,647	18,442	153,205	14,241

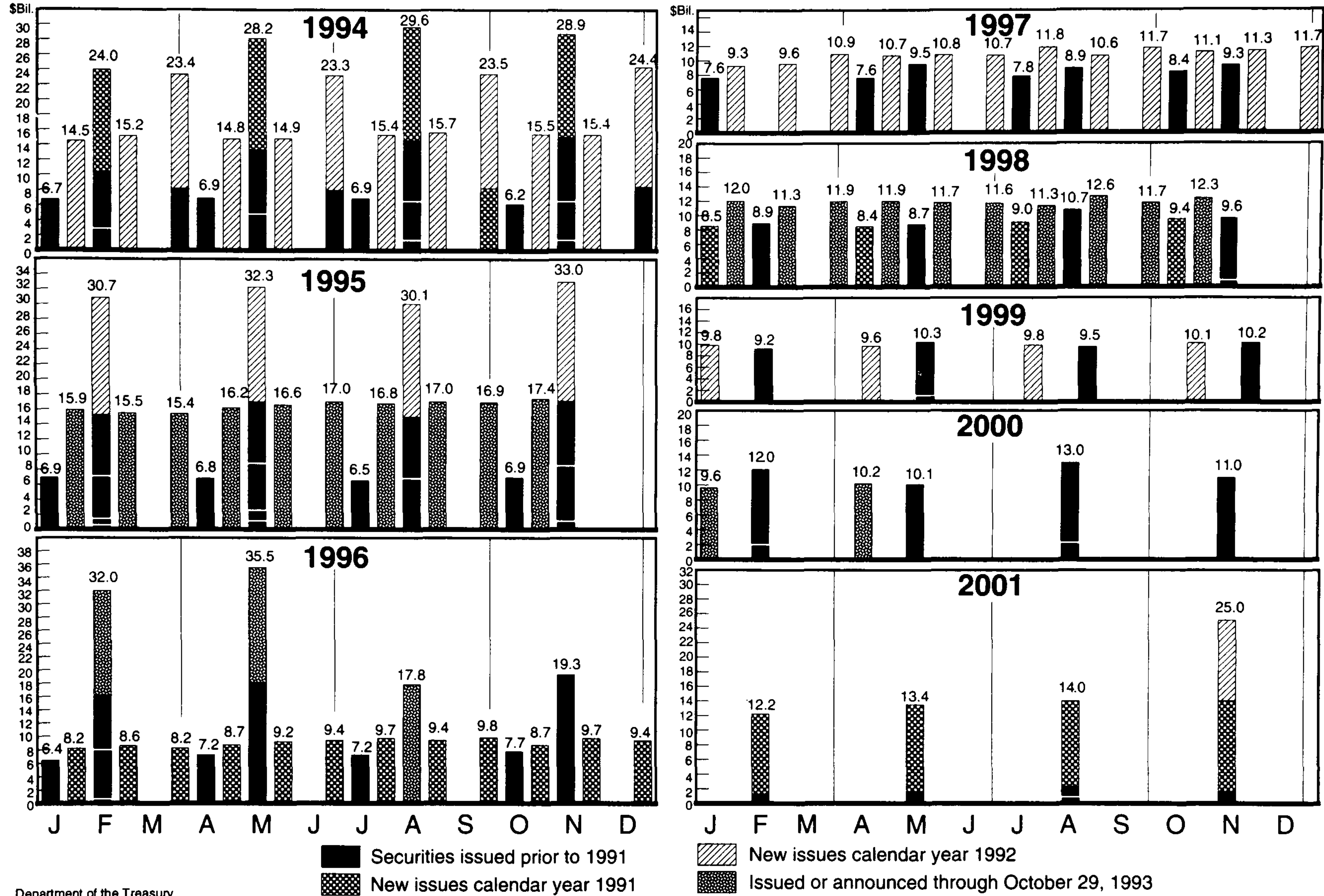
1/ F.R.B. custody accounts for foreign official institutions; included in Private Investors.

Department of the Treasury
Office of Market Finance

November 1, 1993-4

TREASURY MARKETABLE MATURITIES

Privately held, Excluding Bills

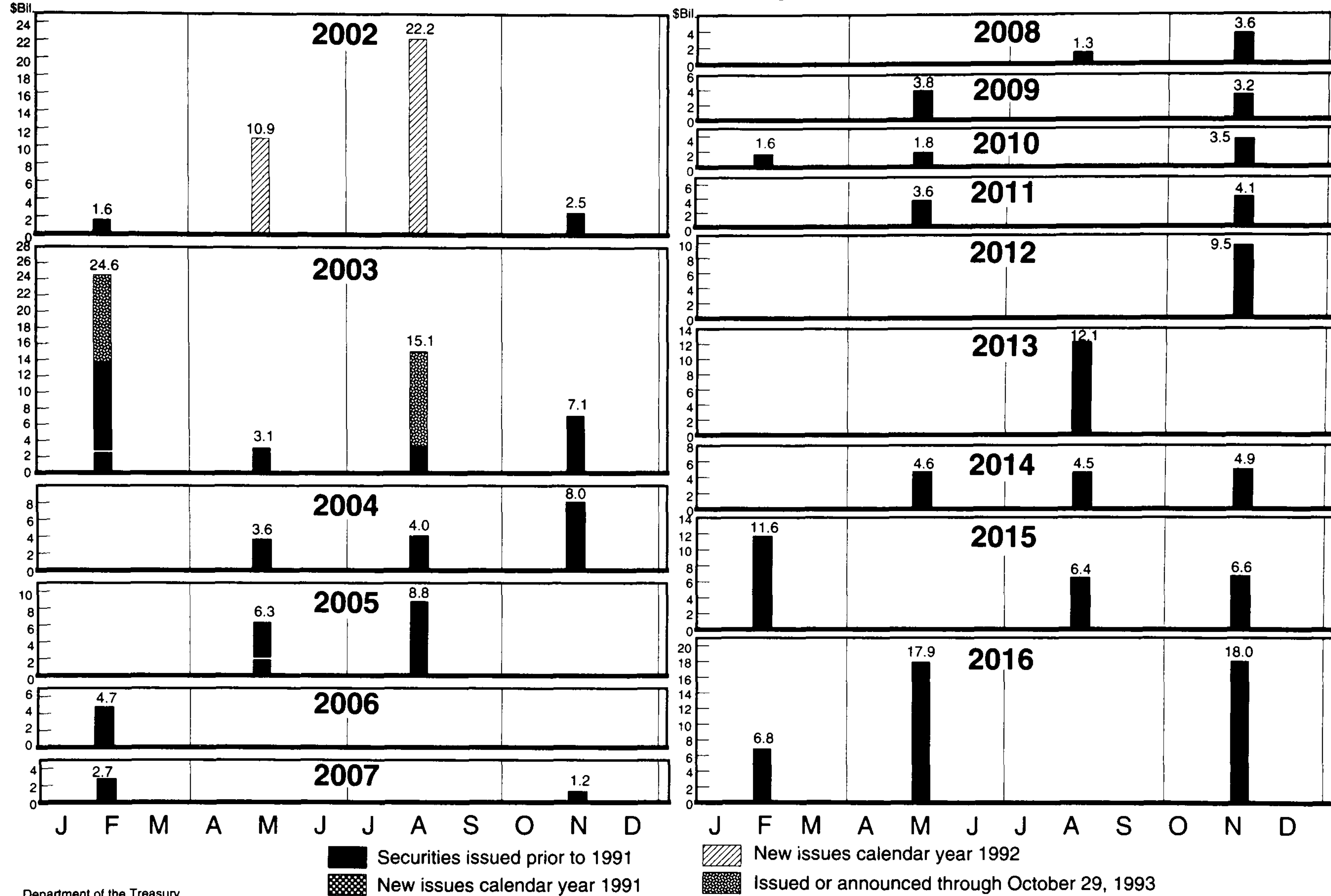


Department of the Treasury
Office of Market Finance

November 1, 1993-6

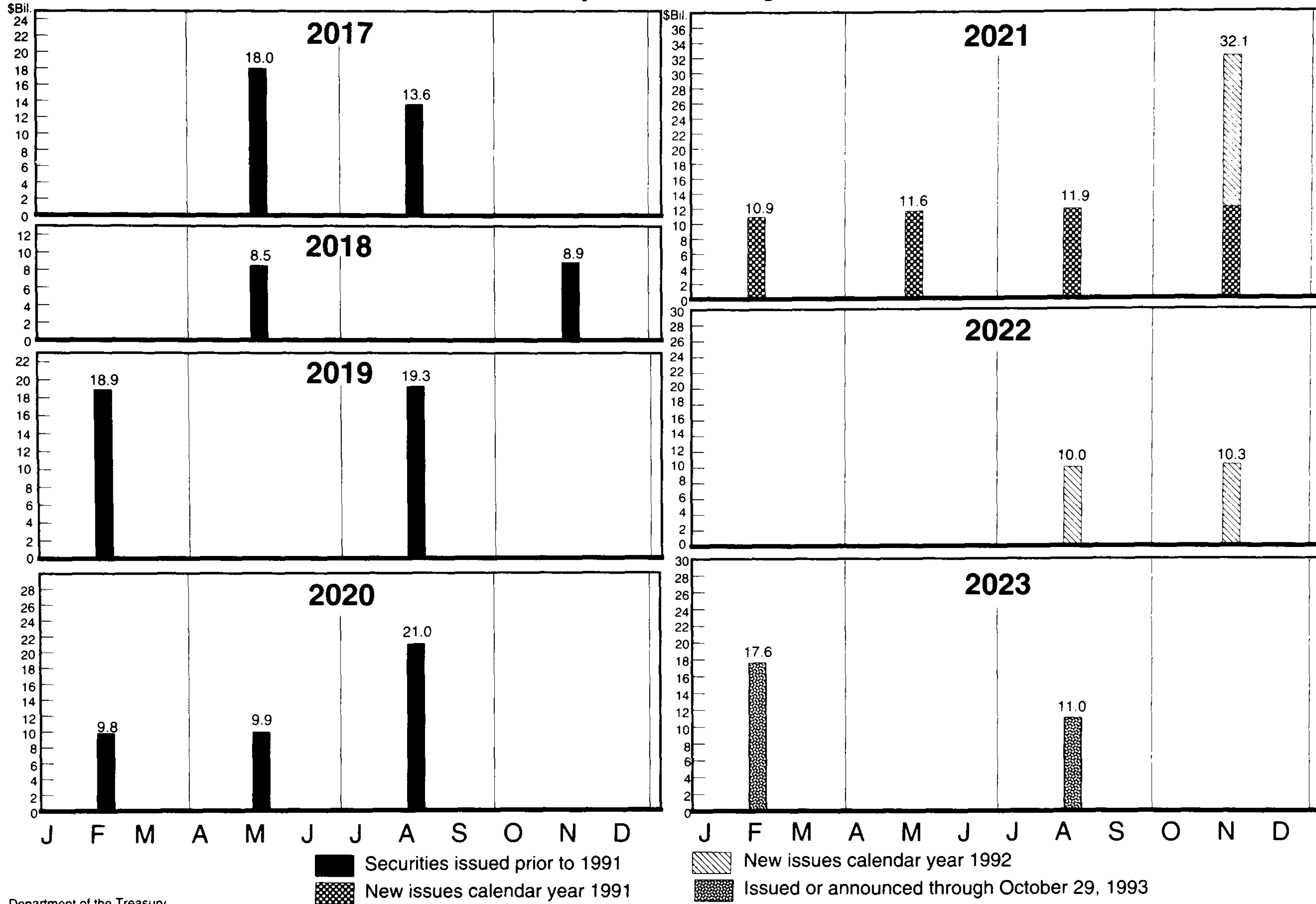
TREASURY MARKETABLE MATURITIES

Privately held, Excluding Bills



Department of the Treasury
Office of Market Finance

November 1, 1993-7



TREASURY MARKETABLE MATURITIES
Privately held, Excluding Bills
$Bil.
2017
18.0
13.6
2018
8.5
8.9
2019
18.9
19.3
2020
9.8
9.9
21.0
2021
10.9
11.6
11.9
32.1
2022
10.0
10.3
2023
17.6
11.0
J F M A M J J A S O N D
Securities issued prior to 1991
New issues calendar year 1991
New issues calendar year 1992
Issued or announced through October 29, 1993
Department of the Treasury
Office of Market Finance
November 1, 1993-8

SCHEDULE OF ISSUES TO BE ANNOUNCED AND AUCTIONED IN NOVEMBER 1993 1/

Monday	Tuesday	Wednesday	Thursday	Friday
1	2	3	4	5 Announce 52 week
8	9 Auction 3 year 2/	10 Auction 10 year 2/	11 Holiday	12
15	16 Auction 52 week 3/	17 Announce 2 year 5 year	18	19
22 Auction 2 year 4/	23 Auction 5 year 4/	24	25 Holiday	26
29	30			

1/ Does not include weekly bills
2/ For settlement November 15
3/ For settlement November 18
4/ For settlement November 30

Department of the Treasury
Office of Market Finance

November 3, 1993-9

SCHEDULE OF ISSUES TO BE ANNOUNCED AND AUCTIONED IN DECEMBER 1993 1/

Monday	Tuesday	Wednesday	Thursday	Friday
		1	2	3 Announce 52 week
6	7	8	9 Auction 52 week 2/	10
13	14	15 Announce 2 year 5 year	16	17
20	21 Auction 2 year 3/	22 Auction 5 year 3/	23	24 Holiday
27	28	29	30 Announce 52 week 4/	31 Holiday

1/ Does not include weekly bills
2/ For settlement December 16
3/ For settlement December 31
4/ For auction January 6 and settlement January 13

Department of the Treasury
Office of Market Finance

November 3, 1993-10

SCHEDULE OF ISSUES TO BE ANNOUNCED AND AUCTIONED IN JANUARY 1994 1/

Monday	Tuesday	Wednesday	Thursday	Friday
3	4	5	6 Auction 52 week 2/	7
10	11	12	13	14
17 Holiday	18	19 Announce 2 year 5 year	20	21
24	25 Auction 2 year 3/	26 Auction 5 year 3/	27	28 Announce 52 week 4/
31				

1/ Does not include weekly bills
2/ For settlement January 13
3/ For settlement January 31
4/ For auction February 3 and settlement February 10

Department of the Treasury
Office of Market Finance

November 3, 1992-11

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TREASURY NEWS

Department of the Treasury | Washington, D.C. | Telephone 202-622-2960

Text as Prepared for Delivery
For Immediate Release
November 5, 1993

REMARKS OF DEPUTY TREASURY SECRETARY ROGER ALTMAN
FORTUNE 500 CONFERENCE
RICHMOND, VA.

In less than two weeks, Congress is going to be taking a vote that will have an important effect on our economy and upon our ability to compete internationally. I want to talk with you about that today and lay out the case why I think you need to let your voice be heard in this debate.

No doubt about it. This is going to be a tough one. But I believe we can win it. The facts are on our side. And I can tell you, if this were a secret ballot, there'd be no question what position would prevail. I think our opposition would say the same if you asked them privately.

Before I get too deep into the detail, let me put this entire debate into perspective. The North American Free Trade Agreement is one element in a coordinated plan by this administration to improve our economic position.

Our overarching economic strategy is to raise investment in this country. That is the only way to raise our productivity, increase real incomes and, above all, improve Americans' standards of living.

We're pursuing this goal through deficit reduction to liberate capital for the private sector. Through investment in our work force, by controlling health care costs to improve business margins, and through trade policy to open export markets.

In that last, broad category, NAFTA is one of three elements. Besides NAFTA, we are committed to a successful conclusion of the Uruguay Round of the GATT negotiations next month. And, we at Treasury are working with the U.S. Trade Representative's office on the framework negotiations with Japan. As I'm sure many of you are aware, Japan's market could be much more open to our goods and services, and we're working to make it so.

We're beginning to make our economy more efficient, with deficit reduction, action in the financial services field, reinventing government, and even more budget cuts.

The evidence of our success lies in the most recent figures our economic reporting units have been putting out. Look at the GDP figure for the third quarter. We think the fourth quarter will be better. Look at new home sales -- up 20 percent -- and auto sales. I notice the auto makers yesterday said they're going to increase production next quarter by 13 percent. And most importantly, look at business investment -- it's up 16 percent.

We've created 1.2 million new jobs in the first nine months of this year. That's more than the Bush administration created in four years. We're averaging 152,000 new jobs per month against their 40,000.

As our work force and businesses become more competitive, we must ensure we have open international markets into which we can sell our goods. The better the prospects for exports, the more export-related investment will result. Such investment improves job security and creates jobs that, on average, pay 17 percent more than other domestic jobs.

Let me quickly point out a few economic consequences of failure to pass NAFTA. There was a study recently by a highly respected independent economic forecasting firm -- Wharton's WEFA. Many of you probably use their services. It's findings were sobering.

It said that if we don't pass NAFTA, ten years from now our unemployment rate will be 0.3 percent higher than otherwise forecast. It said that if we don't pass NAFTA, there will be 170,000 fewer manufacturing jobs in this country, and overall there will be a half-million fewer jobs in a decade. And it said that if we don't pass NAFTA, this country's Gross Domestic Product will be $43 billion less than it could be. That works out to $330 for every working American.

This study in and of itself is justification alone for passing NAFTA.

But there are plenty of other reasons, and I would like to elaborate on a few of them.

Forty-one of our governors and a dozen nobel prize-winning economists endorse it. The Congressional Budget Office, the General Accounting Office, and countless independent studies all confirm that NAFTA is good for the economy.

Beyond being a vehicle to expand trade and create jobs, NAFTA is the first step toward solidifying our trading position in Latin America.

Our economy, to a larger degree than most realize, runs on trade. One job in every eight depends directly on trade. In the most basic sense, we must ask ourselves whether increased exports have ever led to fewer jobs? Of course not. Has increased trade ever led to less prosperity? Never.

Mexico began relaxing its trade restrictions in 1986. The progress since then has been phenomenal. Our position has improved from a deficit approaching $6 billion to a surplus which exceeds $5 billion. That is because the barriers have been coming down, and because Mexico likes our products. They obtain 70 percent of their imports from the United States. The effect of Mexico's decision to pursue fair trade and to buy from a neighbor has been to create about 400,000 more jobs in our economy -- and I would note they are higher paying jobs. We have in NAFTA the opportunity to add another 200,000 jobs, in the first two years alone.

One of the other primary benefits of NAFTA is that it levels out the playing field. At the moment, although Mexico has made substantial progress, the field tilts heavily toward Mexico. At the heart of this agreement is the fact that Mexico will give up far more in the way of trade restrictions than will the United states. With NAFTA, Mexico is dropping tariffs 2 1/2 times what ours are.

Our Big Three auto makers sold a few thousand U.S.-built vehicles in Mexico last year. There are some very protectionist rules about being able to sell there only if you locate production facilities in Mexico. The auto makers tell us that they believe that in the first year alone, they will sell 60,000 vehicles. There's a very significant potential market in Mexico for automobiles. For example, today, just one Mexican citizen out of every 16 owns a car. And half of those cars are 10 years old.

In addition, when Mexico's 20 percent tariff disappears, the American car shipped to Mexico will have a 20 percent cost edge over the Japanese care shipped over from Japan.

I would point out that the congressional Office of Technology Assessment had a study about the comparative costs of producing automobiles in the United States and Mexico, and it came out way in our favor. It said American auto makers could make the same car in the United States for $410 less than it would cost to produce the vehicle in Mexico. That adds to our edge, and it makes the case against those who claim that jobs will flock south with NAFTA.

I had lunch with Lee Iacocca earlier this week, and he made a very compelling case for NAFTA, and how it can affect sector after sector of our economy. He correctly pointed out that every time NAFTA creates an advantage for goods produced in the North American market, the reverse of that means that there is a disadvantage for our trade competitors.

Congress will take its vote in 12 days. I would remind you of what President Clinton pointed out so bluntly about the impact of a vote against NAFTA. The morning afterwards, the Europeans and Japanese will be landing at Mexico City's airport. Their briefcases will be full of contracts, and they'll be eager and anxious and delighted to take our business away from us. When you hear them talk about what a terrible thing NAFTA is, it makes the case for passage even stronger.

Some people have been saying that this administration is trying to make a political case, rather than an economic one, by talking about our trade competitors in terms of NAFTA. There is a compelling economic case to be made here. NAFTA will increase our competitiveness with Japan and with Europe.

We're pretty good in this country about going after a market when we see one. But American businesses aren't the only ones who know how to market themselves.

Since 1986, American trade with Mexico has risen 2.3 yimes faster than our exports globally. This is our fastest growing export market. While their dollar volume is not near ours at this point, Japanese exports to Mexico in the past decade have grown by 500 percent. And the rate for the EC is 350 percent.

To turn my analogy about the automobile tariffs upside down, if we walk away from NAFTA, we could be looking at a situation in which a car built in Detroit will face a 20 percent tariff getting into Mexico, and the Japanese car brought in from Japan will have a 20 percent cost advantage.

It is worth pointing out that NAFTA will be bringing production back to North America. The fact of the matter is we'd far prefer that any production that left the United States come back to North America. Take the example of textiles and apparel. NAFTA will make it possible to bring that production back to Mexico and the United States. When our clothing is made in China, the textiles don't come from the United States. Instead, they are produced in Japan. But when apparel is made in Mexico, the textiles are bought from the United States.

This is the first trade agreement that our textile makers have ever supported.

The last point I want to make about NAFTA is about global economic strategy. Japan has done quite well for itself by providing goods for the emerging markets in Asia, a regional strategy if you will. The same can be said for Europe. To compete globally -- and I would remind you we are in the unique position to compete easily across both the Atlantic and the Pacific -- we need to strengthen our own position with a regional strategy.

Consider these illustrative figures. The developing nations in Asia and Latin America had roughly the same trade levels 20 years ago. In that time, Japan has built its Asian trade to a market of as much as $150 billion. The Latin American market, virtually next door to us, has lagged. It has increased by only one-third, while Asia's trade has quintupled. If trade in Latin America had grown like Asia's trade, up to 4 million Americans would be working at better-paying export-related jobs, and American businesses would be doing something on the order of $200 billion a year in Latin America.

Even at the Treasury Department that's real money.

NAFTA is more than just a trade agreement with Mexico. NAFTA is a critical first step in opening a very willing market in Latin America. Free markets and democracies are spreading throughout Latin America. Taking advantage of the stability that those can provide will offer us expanded trading opportunities, and that in turn will produce even more jobs for our economy. When we adopt NAFTA, we get more than just access to the Mexican market.

In the final analysis, NAFTA is a positive sum game for the United States, Canada and Mexico.

Recently, the president characterized NAFTA as a choice between embracing change and creating the jobs of the future, or clinging unsuccessfully to the jobs of the past. Americans are optimists. We have always adapted to change and looked to the future. And we have prospered by doing so. I would add that we've never been afraid to compete in the international marketplace. This is no time to suggest that we prefer protectionism to competition.

I would like to conclude my remarks by reminding you that we have an important education job to accomplish here. We've got a good trade agreement here, but I don't think that fact is as widely known as it ought to be. I'm going to do my part in spreading the world. I hope you will too.

Thank you.

-30-

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

REMARKS BY
LAWRENCE H. SUMMERS
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY
AT THE
CITIZEN'S NETWORK CONFERENCE
ON LATIN AMERICA IN THE GLOBAL ECONOMY
WASHINGTON, DC
NOVEMBER 3, 1993

I A New Ideology.

I'm pleased to be here today to talk about why a growing and prosperous Latin America is important to the United States. Henry Kissinger, speaking on NAFTA yesterday, pointed out that, with the end of the Cold War, the United States' guiding foreign policy for the past 40 years no longer fits. He noted that our new direction would be one over unfamiliar ground, but we cannot shirk it. Many others have echoed that sentiment in the run-up to the NAFTA vote, two weeks from now.

This pivotal point for American foreign policy is as crucial for the next 40 years as the decisions taken after World War II were for the previous 40 years. Now, in the post Cold War era, the United States can no longer define itself by what it stands against. It must define itself by what it stands for.

What does the United States stand for? It stands for a prosperous world that supports democratic ideals and free market principles. A world that cares about human rights and the environment. A world in which America can also prosper. Promoting prosperity in our country and abroad is the guiding principle of U.S. international economic policy. Indeed, it is the guiding principal of U.S. foreign policy, for prosperity encourages democracy, and democracy underwrites peace.

Historians have said that democracies never go to war. Economists add that democracies rarely have hyperinflation. It is no accident that, during the 1980's, as democratic values strengthened in Latin America, inflation began falling.

II Growing Relationship between Latin America and the United States.

A prosperous Latin America is especially important to the United States, not least because Latin American markets provide an enormous opportunity for U.S. exporters and U.S. investors.

A. Trade

As a result of market opening and other reforms undertaken over the last several years, Latin America currently represents the most rapidly growing regional market for U.S. exports. Since 1986, U.S. exports to the region have increased by 145% to $75 billion in 1992. The demand for U.S. products will continue to rise as Latin American markets expand: the region has become the second fastest growing region in the world.

We're not alone in recognizing Latin America's potential. For Japan, too, Latin America is a growing, reliable export market. In 1991 and 1992, Latin America and the Caribbean represented Japan's second fastest growing market, second only to the Middle East.

Latin America is also a major source of products. Two-way trade between countries in the region and the United States doubled between 1987 and 1992, growing by 15% in 1992 alone. In 1991 and 1992, Japan was Chile's biggest customer, mainly buying minerals and agricultural products.

The mutual gains from open trade are indisputable. For example, Latin America has developed into an important manufacturing region. Manufactures account for about one third of all Latin exports, up from 10% two decades ago. These manufactured exports require capital goods, high technology goods, intermediate products and services exports, many of which are provided by the United States.

B. Investment

Latin America and the Caribbean have also become good places for Americans and others to invest: foreign portfolio and direct investment in the region totalled $57 billion in 1992, as compared to $4 billion in 1989.

If those investment statistics weren't impressive enough, listen to this: international bond issues in Latin America rose from $833 million in 1989 to $6.5 billion in 1991. International equity issues from companies in the region grew from $98 million in 1990 to $4 billion in 1991 (includes privatization).

What are the effects of these inflows? Aside from stimulating demand, causing a boom in stock and real estate markets, and building up foreign exchange reserves, they have provided crucial financing for privatization and investment. The IDB estimates that 1/2 of direct foreign investment entering the region in 1991 financed the acquisition of newly privatized mines, banks, telephone and other companies.

However, capital inflows represent both an opportunity and a challenge for Latin American policy makers. The inflows have triggered: appreciation of real exchange rates; inflationary pressures, and large trade deficits.

C. Foreign Policy Objective: Democracy.

And, as I mentioned before, aside from the enormous market opportunities for U.S. exporters and investors in Latin America, prosperity in the region fulfills our main foreign policy objective: fostering strong, resilient, and broad-based democracies in the region and laying the foundation for peace.

III The New Era of Putting People First.

There are strong parallels between the reforms taking place in Latin America and the Administration's policy of lowering interest rates and reducing the budget deficit. Both free resources to allow investment in people -- through initiatives on education, health care and the environment, to mention a few.

This is a reversal of the policies of the 1980s. For both Latin America and the United States, the early 1980s were marred by high interest rates and record debts; the 1990s offer the promise of the opposite: low interest rates and reduced debts. The 1980s saw regional disputes over contras, commandantes, and human rights; the 1990s will be devoted to promoting greater regional integration. The early 1980s witnessed protectionism, stagnation, and burdensome regulation in Latin America, but the 1990s can be a decade of mutual accord over hemispheric growth, political plurality, and environmental sustainability.

IV. IDB Lending

These ambitious goals will require a steady flow of foreign investment and capital into the region. We look to the IDB to be a catalyst for sustaining and deepening the trends that are already taking place in Latin America. The IDB's investment sector loans, technical assistance, and other projects have been critical to bring about investment sector and financial sector reforms.

We look forward to grants and loans that will be issued through the Multilateral Investment Fund to, among other things, retrain workers affected by privatization and improve regulatory systems for a variety of areas. I'd like to acknowledge Japan's generous cofinancing of IDB projects and contribution to the MIF. The U.S. and Japan are also cooperating to stimulate growth in Latin America through bilateral assistance projects and through helping to resolve debt problems.

We believe that, in the upcoming replenishment, the Bank must play a far more aggressive role in advancing human welfare by supporting better programs in basic education, health, sanitation and education. A vibrant private sector can assume greater responsibility for university education, freeing scarce public resources for primary education. We believe the Bank also has a critical role in advancing health care: there are too many big hospitals that benefit the elites in Latin America and too few primary health care facilities for the poor and in rural areas. Recent studies have shown that Latin America, on the whole, is performing worse on certain measures of the standard of living than other countries with similar per capita incomes -- in areas such as education and income distribution. The Bank can also help address judicial reform and important issues such land tenure.

We also ask that the Bank -- and more importantly its member governments -- maintain a strong commitment to structural reform and the private sector. We believe that Bank resources can be stretched further, without imposing new costs on lenders, through greater use of private cofinancing arrangements. We are also asking the Bank to strengthen its commitment to environmental protection. There is no reason why structural adjustment and environmental integrity cannot go hand in hand, and the U.S. will work closely with member countries and Bank officials to help realize this potential.

V. NAFTA will determine the course of our future relationship with Latin America.

I've heard concerns that this Administration has not been sufficiently engaged in Latin America. I understand the concern but I refute the conclusion. Look at NAFTA. NAFTA is the litmus test for our commitment to Latin America. There is absolutely no question about the Administration's commitment to NAFTA.

As I said before, the NAFTA vote is a pivotal point in American foreign policy. The NAFTA vote will undoubtedly determine the course of the United States' future relationship with Latin America. So you will see a lot of energy going into the NAFTA fight. Under the surface it's a fight to continue our growing relationship with all of Latin America.

I am confident that NAFTA will pass. The Panama Canal vote looked much bleaker 14 days before it was taken, but in the end we did the right thing. NAFTA's critics are simply afraid to keep our country moving forward. However, deep down, they must know it's right thing to do. President Clinton said yesterday that a secret vote taken on NAFTA today would pass by a wide margin. He hoped the undecided members of Congress would be able to make the politically difficult decision of putting long term hope over short term fears. Let me repeat: NAFTA is a vote for hope over fear.

People do have a lot to worry about. Indeed, President Clinton was elected to fix the things NAFTA's opponents worry about. They worry about jobs lost to Mexico, about low Mexican wages, about investment leaving the United States, about lost American competitiveness, the border environment... These are all valid concerns. But one thing is certain. Without NAFTA, nothing will happen to solve any of these problems. NAFTA offers the prospect of real progress.

NAFTA is the first trade agreement to address labor and the environment. Assistant Secretary Jeff Shafer has been working with the Mexicans to improve cooperation and increase financing for border environmental infrastructure projects. He testified on the Hill last week that the agreement offers a new model for international cooperation at the local level to design, finance, and build environmental projects that will improve the lives of citizens on the border.

We already know that open trade between the United States and Mexico will make both countries more competitive. Trade between our countries has exploded since Mexico has been dismantling its trade barrier wall. U.S. exports to Mexico have increased 228% since 1986 to $40.6 billion in 1992.

NAFTA critics, however, are more concerned about NAFTA's investment effects. Dwarfing any effect of a U.S. firm moving to Mexico is the stimulation of trade North America will get from economic integration. Look at what Japan has done in Eastern Asia. Japanese firms invest in assembly operations in lower wage regions. Components are shipped from Japan and incorporated into products bound for the rest of the world. While Japan maintains its trade surplus vis-a-vis its lower wage partner, both gain from increased production and exports.

For the United States, production-sharing with Mexican operations already has improved, and will continue to improve, firms' competitiveness on both sides of the border. Since this conference focuses on the U.S. and Japan in Latin America, I want to address a concern some have expressed that NAFTA represents regional protectionism against the rest of the world.

I do not believe that to be true. NAFTA is market-opening, not market-closing. We have never criticized Japan's close relationships with its trading partners in east Asia, because we realize it is a win-win situation that does not have to detract from our relationship with either party. The NAFTA does not raise any barriers to the world outside of North America and it is fully consistent with our GATT obligations. I think I can go so far as to say that NAFTA could actually stimulate trade with our trading partners outside the region, because of the profound impact it will have on growth, particularly in Mexico.

Let me add that, with NAFTA, we expect that North America will become a magnet for companies who want to trade all over the world. It is optimally placed to take advantage of the three largest markets in the world: Europe, Asia, and the Americas.

However, I don't agree with the latest theory of NAFTA's opponents. They think NAFTA will cause the Japanese to "buy up" Mexico, in an effort to improve their access to the rich U.S. market. Nice try, NAFTA opposition. As I said before, NAFTA does not raise barriers to the outside world, but it doesn't lower them either. To take advantage of the lowering tariffs between the United States and Mexico under NAFTA, according to NAFTA rules of origin, a Japanese company in Mexico would have to increase, by a substantial margin, their use of North American inputs in their products.

VI. Other Intraregional Trading Arrangements.

Passage of NAFTA will continue the momentum of Latin American development. Already the prospect of the agreement has spurred an increasingly complicated web of intraregional trade agreements, such as Mercosur, the Andean Pact and the Central American Common Market. These arrangements have prompted new trade where little or none had existed.

- In 1992, two-way trade between the 11 largest Latin American countries surged to almost $40 billion, or 28% more than in 1991.

- Chile and Argentina have more than doubled their bilateral trade since 1990, to more than $1 billion last year.

- Mexico and Chile's free trade agreement, signed in 1991, resulted in a 42% increase in trade during the past year.

Several Latin American countries have also taken steps to link their financial markets. Venezuela and Argentina have issued bonds and shares on the stock exchanges in Colombia and Brazil, respectively. Four Central American countries are planning the opening of a regional stock exchange.

Secretary Bentsen recently heard a good example of the growing interdependence in the region: two years ago, there was only one flight per day between Caracas and Bogota, now there are five. At the same time, trade between the two countries almost doubled.

VII. Conclusion

Putting people first is working. It is working in Latin America, and it is starting to show results in the United States. As we move together through the next decade, our partnership with Latin America will continue to deepen and move forward. With the help of that partnership, with NAFTA, with the support of Latin America's other friends -- including Japan, Europe and the MDBs -- but most of all through the continued efforts of the region's people and their democratic leaders, I am confident that Latin America will continue to grow and prosper, and will be an example for the rest of the developing world.

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TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

TESTIMONY OF ROGER ALTMAN
DEPUTY SECRETARY
DEPARTMENT OF THE TREASURY
BEFORE THE SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON INTERNATIONAL TRADE
ON THE U.S.-JAPAN FRAMEWORK FOR A NEW ECONOMIC PARTNERSHIP
Monday, November 8, 1993

Thank you, Mr. Chairman. I appreciate the chance to give the Committee an update on progress in our discussions with the Japanese Government under the U.S.-Japan Framework.

When Under Secretary Spero and Ambassador Barshefsky and I last testified before this committee on July 22nd we had just completed the Framework Agreement with the Japanese government. We felt we had a good basic agreement on the macroeconomics, and that we had provided a structure for ongoing negotiations in five areas, or baskets, which would allow us to conclude solid agreements within relatively tight deadlines.

At the time, we tried to make clear that the real work was still to come in the actual negotiations on specific issues. Based on the past few months of negotiations, I can assure you that was no underestimation.

In my testimony today, I would like to outline for you some important economic policy developments in Japan and give you a broad overview of progress in negotiations.

Economic Policy Developments

When we were last here, Prime Minister Hosokawa's coalition government had just entered office, as you may recall. Since then, his government has had to face a significant deterioration in Japan's economic prospects. The economy has continued to falter despite the monetary and fiscal actions taken over the past two years. In fact, the government's public investment programs are providing practically the only source of domestic demand growth.

The fundamental problem Prime Minister Hosokawa faces is the weakness in private domestic demand. This is the result of sluggish consumption and falling private investment. Japanese firms, which invested heavily in plant and equipment in the late 1980s, have cut back their investment spending sharply as a result of the prolonged slump in sales and profits. And, consumption, by far the largest component of domestic demand, has slowed sharply since 1990. Households have felt their wealth eroded by declines in the stock and real estate markets that followed the bursting of the "bubble economy." As wealth and income have fallen, consumption has suffered.

Most economists are projecting that Japanese growth will be negative this year, for the first time in nearly two decades. Weak domestic demand has been one factor in the recent increase in Japan's current account surplus.

Japan's current account surplus is expected to top $140 billion this year. These surpluses have ranged widely in recent years from 4 percent of GDP in 1986 to less than 1.5% in 1990, and are likely remain above 3 percent this year and next.

This is a problem because large surpluses are draining demand from an already-weak global economy and invite pressures for protection. The world needs a sustained period of domestic demand-led growth from Japan -- a period in which demand for goods exceeds domestic supply so that Japan will become a net supplier of jobs to the rest of the world instead of a net drain on jobs. This is why Japan has recognized it needs to make a highly significant reduction in its current account surplus.

The Japanese Government has responded to the deteriorating economic situation and growing current account surplus with a series of fiscal packages. The most recent, in September, included: some new public investment spending, actions to increase the pass-through of the benefits from the strong yen to Japanese consumers, and a number of specific deregulation measures. Then, less than a week later, Japan's discount rate was cut to an all-time low of 1.75%.

At that time we welcomed those measures, which would help to offset the worsening economic outlook. However, we also were reassured that the Government realized more action would be needed, both to get the economy moving again and to reduce Japan's current account surpluses. Economic growth is also conducive to economic reform. It is easier to liberalize a growing economy than a shrinking one.

In short, a growing economy will allow the Government to meet the commitments that Japan made to its G-7 partners at the Tokyo Summit, to the U.S. in the Framework Agreement, and to the voters in this summer's elections.

The Japanese government is now considering a number of important policy actions along these lines.

Fiscal Measures

Most importantly, a stimulative package of tax measures would help to jumpstart consumption. A tax package designed to put more money in the hands of consumers could help build the kind of confidence that Japanese consumers need in order to start making new expenditures. Strong fiscal action through a stimulative tax program could be the key to reviving growth. And a strong, growing economy is the best way to reduce Japan's current account surplus.

The size and composition of the tax package will be critical in determining the package's impact on the economy. The tax package being discussed includes an income tax cut followed by an increase in the consumption tax after some interval.

Many Japanese observers have recognized that the impact of the overall package will have to be substantial to achieve strong growth in domestic demand and meaningful reduction in Japan's current account imbalance. Our primary concern is that the overall stance of fiscal policy be supportive of growth. A tax package that was quickly offset by measures to raise new revenues or cut expenditures would not provide sufficient stimulus to revive the economy. This would be a disappointing event.

Japan has the strongest fiscal position in the G-7. It has the ability to construct a package that is substantial enough to revive growth. Public investment also needs to be maintained at current levels if the tax package is to provide net additional support for the economy.

A government advisory council is debating the overall tax reform package and will present its recommendations to the Prime Minister on November 16th. I expect that the President and the Prime Minister will spend some time in Seattle talking about these issues.

Economic Reform and Deregulation

Aside from its direct economic benefits, economic stimulus is also important because it creates a favorable environment for the Hosokawa Government's other major economic policy initiative -- deregulation. Prime Minister Hosokawa has targeted deregulation as the best way to increase the openness of the Japanese economy and create a more consumer-oriented economy. Coincidentally, a report outlining this deregulation program is to be released today.

Based on press reports, we anticipate that many of the report's proposals will parallel what we have been suggesting in our negotiations in the Framework -- for example, the idea that economic activity should be free in principle and regulated only by exception. We also expect the recommendations will include a follow-up mechanism, helping to ensure that the deregulation proposals are implemented.

I am encouraged by the new environment in Tokyo. The Hosokawa government seems sincere in its commitment to political and economic liberalization and reform. The Diet is debating a wide-ranging political reform program which could give a new, more effective voice to many who feel left out of the system.

I also see Japan's recent commitment to reform the construction industry as proof that the Hosokawa Government is willing to challenge entrenched interests. By taking this difficult step, which surprised many observers, Prime Minister Hosokawa showed that he is serious about economic cooperation with the United States and reform.

Progress on Framework Negotiations

I am hopeful that this same commitment to reform will be reflected in the Framework negotiations. While it is too early to see results, let me give you a brief overview of what is happening in the Framework talks.

As you may recall, there are five different negotiating baskets under the general Framework rubric. In addition, there are two different time frames: "high priority" negotiations, to be completed in time for a meeting between President Clinton and Prime Minister Hosokawa early next year; and all other negotiations to be finished by next summer.

The "high priority" negotiating sectors are: insurance, autos, and government procurement. In addition, we have agreed to the Japanese request that discussions on U.S. export promotion and competitiveness efforts also be considered a "high priority". Since the insurance and government procurement negotiations are lead by USTR and autos and auto parts by Commerce, Ambassador Barshefsky and Acting Under Secretary Hauser can best describe the status of these talks.

An advantage of the Framework is that we have senior Administration officials heading up the baskets. This means that all negotiations can have the benefit of a high-level "push" if needed -- and in my experience that push is always needed.

Since the negotiating kick-off in September, we have held initial meetings on all negotiating groups and follow-up meetings in the high-priority groups. Given the number of negotiating groups, one or another of them is meeting almost every week.

Thus far, both sides have only laid out initial positions -- no changes have been agreed upon. This is not surprising. Negotiations have a dynamic of their own, and the most progress comes right before the deadline.

This is not to say that the talks are not animated. We have been adamant in adhering to the fundamental goal of the Framework: there should be substantially increased access for, and sales of, competitive foreign goods and services. We are proposing a number of market opening and macroeconomic measures to accomplish this goal. This is a basic objective of the Framework, and we are holding the Japanese to it.

Let me just say a few words about financial services, because that is an area that is of particular interest to the Treasury Department. In our negotiations, we have laid out the steps that are needed to secure market access in Japan comparable to the access Japanese firms enjoy in the U.S. We are focusing on pension fund management, mutual fund management, and securities -- areas in which US firms have a demonstrated ability to compete in world markets and are recognized leaders in innovation. In this context, I would like to add that the Treasury Department supports the proposed legislation on Fair Trade in Financial Services because it is a useful lever to open foreign markets and to obtain the same treatment for U.S. firms in foreign markets that foreign firms enjoy in our market.

Next Steps: APEC Bilateral and Sub-Cabinet Meetings

Let me briefly outline where we are headed over the next few months. When President Clinton meets with Prime Minister Hosokawa at the APEC Summit in mid-November, he will stress two key economic issues: the need to revive growth in Japan and to reduce the current account surplus, and the importance we place on getting good agreements in the Framework.

We will also be holding a bilateral sub-Cabinet meeting on the Framework to hammer out the final details of the high-priority agreements and get them into shape for the Heads-of-Government meeting early next year.

Productive meetings at APEC and at sub-Cabinet meeting will be critical steps in the process that was set in train in July when we established the Framework.

Some Myths About the Framework

Before closing, let me address a myth about the Framework that has cropped up in the press, the economics fraternity and elsewhere, over our Japan policy. I might say that I find it quite remarkable and off the mark. It is said that we are seeking managed trade with Japan. This is false. We have consistently said that our goal is to unmanage trade in sectors like public procurement where Japanese trade policy has interfered with market forces to the disadvantage of foreign firms. Such interference has been so widespread in the past that we have no interest in encouraging the Japanese Government to take a more active role in its markets.

It is unmanaging trade -- not managing it -- to monitor purchases by the government of foreign telecommunications equipment relative to what happens in other markets. It is unmanaging trade -- not managing it -- to compare Japanese public purchases of supercomputers with the share held by U.S. products in other public procurement markets.

I hope I have brought you up to date on the economic situation in Japan and our progress under the Framework. I also hope I have dispelled certain myths about the Framework that have cropped up over the past few months. Thank you.

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TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

FOR RELEASE AT 2:30 P.M.
November 5, 1993

CONTACT: Office of Financing
202/219-3350

TREASURY'S 52-WEEK BILL OFFERING

The Treasury will auction approximately $16,000 million of 52-week Treasury bills to be issued November 18, 1993. This offering will provide about $1,750 million of new cash for the Treasury, as the maturing 52-week bill is currently outstanding in the amount of $14,259 million. In addition to the maturing 52-week bills, there are $24,561 million of maturing 13-week and 26-week bills.

Federal Reserve Banks hold $9,675 million of bills for their own accounts in the three maturing issues. These may be refunded at the weighted average discount rate of accepted competitive tenders.

Federal Reserve Banks hold $3,441 million of the three maturing issues as agents for foreign and international monetary authorities. These may be refunded within the offering amount at the weighted average discount rate of accepted competitive tenders. Additional amounts may be issued for such accounts if the aggregate amount of new bids exceeds the aggregate amount of maturing bills. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $390 million of the maturing 52-week issue.

Tenders for the bills will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. This offering of Treasury securities is governed by the terms and conditions set forth in the Uniform Offering Circular (31 CFR Part 356, published as a final rule on January 5, 1993, and effective March 1, 1993) for the sale and issue by the Treasury to the public of marketable Treasury bills, notes, and bonds.

Details about the new security are given in the attached offering highlights.

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Attachment

LB-488

HIGHLIGHTS OF TREASURY OFFERING OF 52-WEEK BILLS TO BE ISSUED NOVEMBER 18, 1993

November 5, 1993

Offering Amount	$16,000 million
Description of Offering:	
Term and type of security .	364-day bill
CUSIP number	912794 L9 3
Auction date	November 16, 1993
Issue date	November 18, 1993
Maturity date	November 17, 1994
Original issue date	November 18, 1993
Maturing amount.	$14,259 million
Minimum bid amount	$10,000
Multiples	$1,000
Submission of Bids:	
Noncompetitive bids	Accepted in full up to $1,000,000 at the average discount rate of accepted competitive bids.
Competitive bids . . .	(1) Must be expressed as a discount rate with two decimals, e.g., 7.10%.
	(2) Net long position for each bidder must be reported when the sum of the total bid amount, at all discount rates, and the net long position are $2 billion or greater.
	(3) Net long position must be reported one half-hour prior to the closing time for receipt of competitive bids.
Maximum Recognized Bid at a Single Yield . . .	35% of public offering
Maximum Award	35% of public offering
Receipt of Tenders:	
Noncompetitive tenders . .	Prior to 12:00 noon Eastern Standard time on auction day.
Competitive tenders	Prior to 1:00 p.m. Eastern Standard time on auction day.
Payment Terms	Full payment with tender or by charge to a funds account at a Federal Reserve bank on issue date.

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

FOR IMMEDIATE RELEASE
November 8, 1993

Statement by Treasury Secretary Lloyd Bentsen

I am concerned that Japanese growth appears to be slowing and Japanese demand for foreign products is increasing less rapidly than had been hoped.

I hope that the Japanese authorities will act to provide substantial stimulus to their consumer spending at this crucial juncture.

LB-489

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR RELEASE AT 3:00 PM
November 4, 1993

Contact: Peter Hollenbach
(202) 219-3302

PUBLIC DEBT ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR OCTOBER 1993

Treasury's Bureau of the Public Debt announced activity figures for the month of October 1993, of securities within the Separate Trading of Registered Interest and Principal of Securities program (STRIPS).

Dollar Amounts in Thousands

Principal Outstanding (Eligible Securities)	$724,746,006
Held in Unstripped Form	$523,675,185
Held in Stripped Form	$201,070,821
Reconstituted in October	$11,402,990

The accompanying table gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form."

Information about "Holdings of Treasury Securities in Stripped Form" is now available on the Department of Commerce's Economic Bulletin Board (EBB). The EBB, which can be accessed using personal computers, is an inexpensive service provided by the Department of Commerce. For more information concerning this service call 202-482-1986.

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PA-133

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, OCTOBER [illegible]

(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month[1]
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
[illegible] 5 8% Note C 1994	11/15/94	$6 658 554	$5 138 554	$1,520,000	$84,400
[illegible] 4% Note A 1995	2/15/95	6 933.861	5 677 221	1,256,640	114,720
[illegible] 4% Note B 1995	5 15/95	[illegible]127.086	4 249 806	2,877,280	17,600
[illegible] 2% Note C 1995	8/15/95	[illegible]955 901	4 992 301	2,963,600	28,000
[illegible] Note D 1995	11 15/95	[illegible]318.550	3 832 950	3,485,600	48,400
[illegible] Note A 1996	2 15 96	8 445 415	[illegible]651 815	793,600	14 400
[illegible] Note C 1996	5 15 96	20 085 643	19 408 843	676,800	64,000
[illegible] Note D 1996	11 15 96	20 258 810	18 106 810	2,152,000	30,400
[illegible] Note A 1997	5 15 97	9 921 237	8 831 637	1 089,600	248,400
[illegible] Note B 1997	8 15 97	9 362.836	[illegible]974 036	1,388,800	32,000
[illegible] Note C 1997	11 15 97	9 808 329	[illegible]537 929	2 270,400	112,000
[illegible] Note A 1998	2 15 98	[illegible]159 068	[illegible]489 308	669 760	6 400
[illegible] Note B 1998	5 15 98	[illegible]165 387	[illegible]756 987	2 408,400	52,000
[illegible] Note C 1998	8 15 98	[illegible]342 646	[illegible]630 646	1 712,000	124 800
[illegible] Note D 1998	11 15 98	[illegible]902.875	[illegible]291 675	2 611 200	24 000
[illegible] Note A 1999	2 15 99	[illegible]719 623	[illegible]039.623	680,000	147 200
[illegible] Note B 1999	[illegible]15 99	[illegible]047 103	[illegible]333 503	2 713,600	14 400
[illegible] Note C 1999	[illegible]15 99	[illegible]163 644	[illegible]395 994	1 267 650	175 975
[illegible] Note D 1999	11 15 99	[illegible]773 960	[illegible]988 360	1 785,600	-0-
[illegible] Note A 2000	2 15 00	10 673 033	[illegible]769 833	903,200	63,200
[illegible] Note B 2000	5 15 00	10 496.230	[illegible]182.630	3,313,600	25,600
[illegible] Note C 2000	8 15 00	11 080 646	8 308 966	2 771,680	176,000
[illegible] Note D 2000	11 15.00	11 519 682	9 304 482	2,215,200	155,600
[illegible] 4% Note A 2001	2 15/01	11 312.802	10 284 002	1,028,800	50,400
[illegible] Note B 2001	5 15 01	12 398.083	10 789 658	1 608,425	118,000
[illegible] 8% Note C 2001	8 15/01	12 339.185	11 171 185	1 168,000	8,000
[illegible] 2% Note D 2001	11/15/01	24 226 102	23 789 622	436,480	4 800
[illegible] 2% Note A 2002	5 15/02	11 714 397	10 887 917	826,480	45,040
6 3 8% Note B 2002	8/15/02	23.859.015	23.579.015	280,000	-0-
6 1 4% Note A 2003	2/15/03	23.562.691	23.560.515	2,176	-0-
5 3 4% Note B 2003	8/15/03	12 932.637	12 842 237	90,400	-0-
11 5 8% Bond 2004	11/15/04	8.301.806	6 303.406	1,998,400	436,800
12% Bond 2005	5/15/05	4 260.758	2 984 708	1 276,050	17,000
10 3 4% Bond 2005	8 15/05	9 269.713	8 310 513	959,200	-0-
9 3 8% Bond 2006	2/15/06	4 755 916	4 755 276	640	-0-
11 3 4% Bond 2009-14	11 15/14	6 005.584	3 581.584	2,424,000	528,000
11 1 4% Bond 2015	2 15/15	12 667 799	6 865 079	5,802,720	1,304,480
10 5 8% Bond 2015	8/15/15	7 149 916	2 842 396	4,307,520	298,240
9 7 8% Bond 2015	11/15/15	6 899 859	3 597 459	3,302,400	1,067,200
9-1 4% Bond 2016	2/15/16	7 266.854	5 592.454	1,674,400	482,400
7 1 4% Bond 2016	5/15/16	18.823.551	18 457.151	366,400	113,600
7 1 2% Bond 2016	11/15/16	18.864.448	17 733.248	1,131,200	65,040
8-3 4% Bond 2017	5/15/17	18.194.169	3 643.929	14,550,240	41,920
8-7 8% Bond 2017	8/15/17	14 016.858	5.752.858	8,264,000	811,200
9-1 8% Bond 2018	5/15/18	8.708.639	2 083.039	6,625,600	236,400
9% Bond 2018	11/15/18	9.032.870	1 069.070	7,963,800	193,000
8-7 8% Bond 2019	2/15/19	19.250 798	3 271.598	15,979,200	507,200
8 1 8% Bond 2019	8/15/19	20 213 832	13 587 912	6,625,920	200,000
8 1 2% Bond 2020	2/15/20	10 228.868	3 433.268	6,795,600	118,000
8-3 4% Bond 2020	5/15/20	10 158 883	1 852.963	8,305,920	37,280
8-3 4% Bond 2020	8/15/20	21 418 606	2 995.406	18,423,200	140,960
7 7 8% Bond 2021	2/15/21	11 113.373	9 830.173	1,283,200	248,000
8-1 8% Bond 2021	5/15/21	11 958 888	4 036.648	7,922,240	220,160
8-1 8% Bond 2021	8/15/21	12 163.482	7 274.842	4,888,640	592,000
8% Bond 2021	11/15/21	32.798.394	14 139.594	18,658,800	1,570,375
7 1 4% Bond 2022	8 15/22	10 352 790	9 256.790	1,096,000	184,000
7-5 8% Bond 2022	11/15/22	10.699.626	9.360.426	1,339,200	164,800

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, OCTOBER 31, 1993—Continued

(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding: Total	Principal Amount Outstanding: Portion Held in Unstripped Form	Principal Amount Outstanding: Portion Held in Stripped Form	Reconstituted This Month[1]
7 1/8% Bond 2023	2/15/23	18,374,361	18,279,961	94,400	27,200
6 1/4% Bond 2023	8/15/23	11,530,334	11,485,374	44,960	-0-
Total		724,746,006	523,675,185	201,070,821	11,402,990

[1] Effective May 1, 1987, securities held in stripped form were eligible for reconstitution to their unstripped form.

Note: On the 4th workday of each month Table VI will be available after 3:00 pm eastern time on the Commerce Department's Economic Bulletin Board (EBB). The telephone number for more information about EBB is (202) 482-1986. The balances in this table are subject to audit and subsequent adjustments.

TREASURY NEWS

Department of the Treasury Washington, D.C. Telephone 202-622-2960

TESTIMONY OF ROGER ALTMAN
DEPUTY SECRETARY
DEPARTMENT OF THE TREASURY
BEFORE THE SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON INTERNATIONAL TRADE
ON THE U.S.-JAPAN FRAMEWORK FOR A NEW ECONOMIC PARTNERSHIP
Monday, November 8, 1993

Thank you, Mr. Chairman. I appreciate the chance to give the Committee an update on progress in our discussions with the Japanese Government under the U.S.-Japan Framework.

When Under Secretary Spero and Ambassador Barshefsky and I last testified before this committee on July 22nd we had just completed the Framework Agreement with the Japanese government. We felt we had a good basic agreement on the macroeconomics, and that we had provided a structure for ongoing negotiations in five areas, or baskets, which would allow us to conclude solid agreements within relatively tight deadlines.

At the time, we tried to make clear that the real work was still to come in the actual negotiations on specific issues. Based on the past few months of negotiations, I can assure you that was no underestimation.

In my testimony today, I would like to outline for you some important economic policy developments in Japan and give you a broad overview of progress in negotiations.

Economic Policy Developments

When we were last here, Prime Minister Hosokawa's coalition government had just entered office, as you may recall. Since then, his government has had to face a significant deterioration in Japan's economic prospects. The economy has continued to falter despite the monetary and fiscal actions taken over the past two years. In fact, the government's public investment programs are providing practically the only source of domestic demand growth.

The fundamental problem Prime Minister Hosokawa faces is the weakness in private domestic demand. This is the result of sluggish consumption and falling private investment. Japanese firms, which invested heavily in plant and equipment in the late 1980s, have cut back their investment spending sharply as a result of the prolonged slump in sales and profits. And, consumption, by far the largest component of domestic demand, has slowed sharply since 1990. Households have felt their wealth eroded by declines in the stock and real estate markets that followed the bursting of the "bubble economy." As wealth and income have fallen, consumption has suffered.

Most economists are projecting that Japanese growth will be negative this year, for the first time in nearly two decades. Weak domestic demand has been one factor in the recent increase in Japan's current account surplus.

Japan's current account surplus is expected to top $140 billion this year. These surpluses have ranged widely in recent years from 4 percent of GDP in 1986 to less than 1.5% in 1990, and are likely remain above 3 percent this year and next.

This is a problem because large surpluses are draining demand from an already-weak global economy and invite pressures for protection. The world needs a sustained period of domestic demand-led growth from Japan -- a period in which demand for goods exceeds domestic supply so that Japan will become a net supplier of jobs to the rest of the world instead of a net drain on jobs. This is why Japan has recognized it needs to make a highly significant reduction in its current account surplus.

The Japanese Government has responded to the deteriorating economic situation and growing current account surplus with a series of fiscal packages. The most recent, in September, included: some new public investment spending, actions to increase the pass-through of the benefits from the strong yen to Japanese consumers, and a number of specific deregulation measures. Then, less than a week later, Japan's discount rate was cut to an all-time low of 1.75%.

At that time we welcomed those measures, which would help to offset the worsening economic outlook. However, we also were reassured that the Government realized more action would be needed, both to get the economy moving again and to reduce Japan's current account surpluses. Economic growth is also conducive to economic reform. It is easier to liberalize a growing economy than a shrinking one.

In short, a growing economy will allow the Government to meet the commitments that Japan made to its G-7 partners at the Tokyo Summit, to the U.S. in the Framework Agreement, and to the voters in this summer's elections.

The Japanese government is now considering a number of important policy actions along these lines.

Fiscal Measures

Most importantly, a stimulative package of tax measures would help to jumpstart consumption. A tax package designed to put more money in the hands of consumers could help build the kind of confidence that Japanese consumers need in order to start making new expenditures. Strong fiscal action through a stimulative tax program could be the key to reviving growth. And a strong, growing economy is the best way to reduce Japan's current account surplus.

The size and composition of the tax package will be critical in determining the package's impact on the economy. The tax package being discussed includes an income tax cut followed by an increase in the consumption tax after some interval.

Many Japanese observers have recognized that the impact of the overall package will have to be substantial to achieve strong growth in domestic demand and meaningful reduction in Japan's current account imbalance. Our primary concern is that the overall stance of fiscal policy be supportive of growth. A tax package that was quickly offset by measures to raise new revenues or cut expenditures would not provide sufficient stimulus to revive the economy. This would be a disappointing event.

Japan has the strongest fiscal position in the G-7. It has the ability to construct a package that is substantial enough to revive growth. Public investment also needs to be maintained at current levels if the tax package is to provide net additional support for the economy.

A government advisory council is debating the overall tax reform package and will present its recommendations to the Prime Minister on November 16th. I expect that the President and the Prime Minister will spend some time in Seattle talking about these issues.

Economic Reform and Deregulation

Aside from its direct economic benefits, economic stimulus is also important because it creates a favorable environment for the Hosokawa Government's other major economic policy initiative -- deregulation. Prime Minister Hosokawa has targeted deregulation as the best way to increase the openness of the Japanese economy and create a more consumer-oriented economy. Coincidentally, a report outlining this deregulation program is to be released today.

Based on press reports, we anticipate that many of the report's proposals will parallel what we have been suggesting in our negotiations in the Framework -- for example, the idea that economic activity should be free in principle and regulated only by exception. We also expect the recommendations will include a follow-up mechanism, helping to ensure that the deregulation proposals are implemented.

I am encouraged by the new environment in Tokyo. The Hosokawa government seems sincere in its commitment to political and economic liberalization and reform. The Diet is debating a wide-ranging political reform program which could give a new, more effective voice to many who feel left out of the system.

I also see Japan's recent commitment to reform the construction industry as proof that the Hosokawa Government is willing to challenge entrenched interests. By taking this difficult step, which surprised many observers, Prime Minister Hosokawa showed that he is serious about economic cooperation with the United States and reform.

Progress on Framework Negotiations

I am hopeful that this same commitment to reform will be reflected in the Framework negotiations. While it is too early to see results, let me give you a brief overview of what is happening in the Framework talks.

As you may recall, there are five different negotiating baskets under the general Framework rubric. In addition, there are two different time frames: "high priority" negotiations, to be completed in time for a meeting between President Clinton and Prime Minister Hosokawa early next year; and all other negotiations to be finished by next summer.

The "high priority" negotiating sectors are: insurance, autos, and government procurement. In addition, we have agreed to the Japanese request that discussions on U.S. export promotion and competitiveness efforts also be considered a "high priority". Since the insurance and government procurement negotiations are lead by USTR and autos and auto parts by Commerce, Ambassador Barshefsky and Acting Under Secretary Hauser can best describe the status of these talks.

An advantage of the Framework is that we have senior Administration officials heading up the baskets. This means that all negotiations can have the benefit of a high-level "push" if needed -- and in my experience that push is always needed.

Since the negotiating kick-off in September, we have held initial meetings on all negotiating groups and follow-up meetings in the high-priority groups. Given the number of negotiating groups, one or another of them is meeting almost every week.

Thus far, both sides have only laid out initial positions -- no changes have been agreed upon. This is not surprising. Negotiations have a dynamic of their own, and the most progress comes right before the deadline.

This is not to say that the talks are not animated. We have been adamant in adhering to the fundamental goal of the Framework: there should be substantially increased access for, and sales of, competitive foreign goods and services. We are proposing a number of market opening and macroeconomic measures to accomplish this goal. This is a basic objective of the Framework, and we are holding the Japanese to it.

Let me just say a few words about financial services, because that is an area that is of particular interest to the Treasury Department. In our negotiations, we have laid out the steps that are needed to secure market access in Japan comparable to the access Japanese firms enjoy in the U.S. We are focusing on pension fund management, mutual fund management, and securities -- areas in which US firms have a demonstrated ability to compete in world markets and are recognized leaders in innovation. In this context, I would like to add that the Treasury Department supports the proposed legislation on Fair Trade in Financial Services because it is a useful lever to open foreign markets and to obtain the same treatment for U.S. firms in foreign markets that foreign firms enjoy in our market.

Next Steps: APEC Bilateral and Sub-Cabinet Meetings

Let me briefly outline where we are headed over the next few months. When President Clinton meets with Prime Minister Hosokawa at the APEC Summit in mid-November, he will stress two key economic issues: the need to revive growth in Japan and to reduce the current account surplus, and the importance we place on getting good agreements in the Framework.

We will also be holding a bilateral sub-Cabinet meeting on the Framework to hammer out the final details of the high-priority agreements and get them into shape for the Heads-of-Government meeting early next year.

Productive meetings at APEC and at sub-Cabinet meeting will be critical steps in the process that was set in train in July when we established the Framework.

Some Myths About the Framework

Before closing, let me address a myth about the Framework that has cropped up in the press, the economics fraternity and elsewhere, over our Japan policy. I might say that I find it quite remarkable and off the mark. It is said that we are seeking managed trade with Japan. This is false. We have consistently said that our goal is to unmanage trade in sectors like public procurement where Japanese trade policy has interfered with market forces to the disadvantage of foreign firms. Such interference has been so widespread in the past that we have no interest in encouraging the Japanese Government to take a more active role in its markets.

It is unmanaging trade -- not managing it -- to monitor purchases by the government of foreign telecommunications equipment relative to what happens in other markets. It is unmanaging trade -- not managing it -- to compare Japanese public purchases of supercomputers with the share held by U.S. products in other public procurement markets.

I hope I have brought you up to date on the economic situation in Japan and our progress under the Framework. I also hope I have dispelled certain myths about the Framework that have cropped up over the past few months. Thank you.

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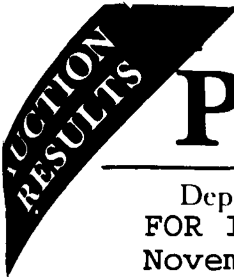


PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
November 8, 1993

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $13,805 million of 13-week bills to be issued November 12, 1993 and to mature February 10, 1994 were accepted today (CUSIP: 912794H80).

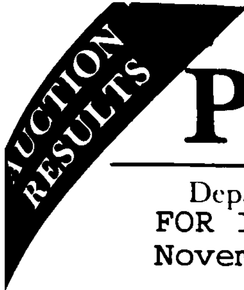
RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	3.09%	3.16%	99.228
High	3.11%	3.18%	99.223
Average	3.11%	3.18%	99.223

$14,850,000 was accepted at lower yields.
Tenders at the high discount rate were allotted 61%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	33,700	33,700
New York	52,085,044	12,565,184
Philadelphia	5,125	5,125
Cleveland	39,441	39,441
Richmond	34,176	34,176
Atlanta	18,180	17,010
Chicago	2,388,242	110,142
St. Louis	13,734	13,734
Minneapolis	8,438	8,438
Kansas City	25,938	25,938
Dallas	13,636	13,636
San Francisco	450,805	50,805
Treasury	887,501	887,501
TOTALS	$56,003,960	$13,804,830
Type		
Competitive	$50,877,401	$8,678,271
Noncompetitive	1,383,249	1,383,249
Subtotal, Public	$52,260,650	$10,061,520
Federal Reserve	2,894,710	2,894,710
Foreign Official Institutions	848,600	848,600
TOTALS	$56,003,960	$13,804,830



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FOR IMMEDIATE RELEASE
November 8, 1993

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $13,915 million of 26-week bills to be issued November 12, 1993 and to mature May 12, 1994 were accepted today (CUSIP: 912794K52).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	3.26%	3.36%	98.361
High	3.28%	3.38%	98.351
Average	3.28%	3.38%	98.351

Tenders at the high discount rate were allotted 16%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

Location	Received	Accepted
Boston	25,982	25,982
New York	61,380,326	12,972,859
Philadelphia	5,352	5,352
Cleveland	31,919	31,919
Richmond	24,135	24,135
Atlanta	24,700	23,020
Chicago	1,111,374	35,574
St. Louis	11,790	11,790
Minneapolis	9,432	9,432
Kansas City	27,622	27,622
Dallas	9,134	9,134
San Francisco	530,103	112,103
Treasury	626,126	626,126
TOTALS	$63,817,995	$13,915,048
Type		
Competitive	$58,639,779	$8,736,832
Noncompetitive	967,816	967,816
Subtotal, Public	$59,607,595	$9,704,648
Federal Reserve	3,150,000	3,150,000
Foreign Official Institutions	1,060,400	1,060,400
TOTALS	$63,817,995	$13,915,048