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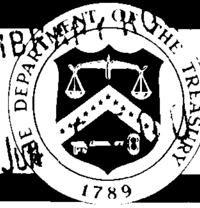
TREASURY  NEWS

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Adv 6:30 p.m. EDT
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June 1, 1995

REMARKS OF TREASURY SECRETARY ROBERT E. RUBIN
NEW YORK ECONOMIC CLUB
NEW YORK, N.Y.

Open any serious newspaper or listen to any broadcast in the past few months and there are stories on the budget, taxes, government programs under attack in Washington, Russia, Mexico, India, Japan, foreign aid, tragically Oklahoma City, Waco, and a long list of like matters. These may seem disparate subjects, but underlying them are three great debates now under way that will affect the future of our country in the years and decades ahead. The Treasury is deeply involved in all three. Let me start by expressing my strong beliefs about each issue.

Firstly, we must, in my view, continue forceful deficit reduction, but on a path determined by a thoughtful weighing of the tradeoffs among all factors involved in creating a healthy economy, not on the basis of arbitrary dates and arbitrary cuts. Secondly, we must engage with the global economy rather than turn inward. Thirdly, we must support law enforcement rather than undermine it.

Before I talk about these choices, let me very briefly set the scene. Most here and abroad believe the United States is better positioned economically than it has been for at least the past 25 years. Government officials and business people I talk to feel that our private sector has substantially improved its global competitive position over the past decade, and our public policy has also changed dramatically during the past 2.5 years. We've reversed a 20-year history of rising deficits and brought down the deficit, down substantially. We've put education, training and other public investments critical to the future of the country at the center of the federal budget. We've opened markets through GATT, NAFTA and nascent efforts in Asia and Latin America. We've reduced the work force of the federal government through re-invention that will, when completed, lead to the smallest civilian federal workforce since John F. Kennedy was President.

The statistics have also been good:

RR-341 (MORE)

- The economy has grown 3.5 percent per annum during the past 2.5 years, versus 1.4 percent during the previous 4 years.

- Inflation has been under 3 percent during the past 2.5 years, versus the 4 percent average during the previous 4 years.

- Unemployment is at 5.7 percent, versus 7.1 percent when the current Administration took office.

- Over 6 million jobs were created during the past 2.5 years, versus 2.4 million the preceding 4 years; and

- The deficit has fallen from 5 percent of GDP at the end of the prior Administration to about 2.7 percent now, and it is projected under the current budget to be 2.1 percent by the end of this decade.

The reason I've gone through this scene setting is that we sometimes forget how stark the difference is between our economic circumstances now and what they were a short three years ago. Having said that, the key now is to focus with great intensity on positioning our economy for the future, and on our social fabric.

Let me pause for a moment to comment on our social fabric. Polls and focus groups show that most Americans do not feel our current prosperity in their lives. One poll about six months ago reported that 60 percent of the American people still thought we were in a recession. For many, if not most Americans, the American dream is felt to be in jeopardy. Hard-working Americans worry about their families, about college and retirement, about wages and foreign competition. And, they worry about their personal safety. Worse, they believe that nobody cares.

One cause of these fears is the increasing inequality in income levels. In the 1950s, '60s and early '70s, all income levels rose at roughly the same rate. But since then, the lowest 60 percent have seen real incomes fall, and only the upper 40 percent have had rising real incomes. This widening gap feeds anger and alienation. People lose hope. Some come to oppose international engagement. They may become more fearful and less tolerant of their neighbors.

We must provide those many who are anxious and angry an effective response, not just to their fears, but to their hopes and dreams for a better life. What is at stake here is not only a healthy economy, but our social fabric. Each of the three imperatives I have described is central to that task.

Let me start with the debate over the budget. The outcome of that debate is central to whether or not we improve standards of living in the United States. The choice is between a process of building a budget based on the policy tradeoffs -- with heavy emphasis on deficit reduction -- that will best promote our economic objectives and building a budget backward to meet an arbitrary balanced budget date.

The President's February budget message, and his oft-stated commitment since is to continue forceful deficit reduction, while at the same time making the public investments absolutely critical for the nation's economic future -- investments in education and training, in apprenticeship programs, child nutrition and the like. And, he has made it clear for 2 and 1/2 years that key to achieving a balanced budget is controlling federal health care expenditures, but again, in a sensible fashion and in the context of broader health care reform, rather than through draconian and arbitrary cuts that will result in severe beneficiary impacts and cost shifting and other distortions. So, once again, the difference is between building a budget that goes to balance based on policy choices, and building a budget based on arbitrary dates, regardless of the policy effects. Education, training and the inner cities will of necessity, suffer substantially, and that is economically non-sensible.

Education is vital in reducing income disparity and promoting economic growth. In 1979, the difference between a high school diploma and a college degree was a 39 percent higher salary each year for the college graduate. By 1993, that disparity had reached 80 percent.

In a global economy, with an information revolution changing the work place and placing greater demands on the work force, it makes no sense to balance the budget by cutting student loans, apprenticeship programs, worker training, school nutrition programs, and incentives for education and educational reform.

About six weeks ago I was in Indonesia for a meeting of finance ministers of Asian and Pacific nations. There were 18 of us around the table. Most were countries which fifteen or twenty years ago were impoverished and today are vastly improved and growing rapidly. It is an amazing success story. One thing these economies have in common is the intense focus on education, which they view as a key element in their development.

Congress is proposing the very different approach I've already describe, to cut the deficit to zero by an arbitrary date, with all the arbitrary, non-policy-driven cuts that must of necessity be made. The House proposal exacerbates this problem because the requirement for deficit reduction is larger in order to absorb the cost of the enormous and, in our judgment, economically unwise tax cuts.

You wouldn't set arbitrary goals for your companies, all based on one of the many variables that will affect the fortunes of your company. And we shouldn't do it for our country.

The second debate over the direction of this nation -- the second choice to be made -- is on the issue of the extent of our international engagement. Growing global economic links and competition from foreign companies have left some Americans behind and have increased anxiety for many more. Just as there is a great divide in the debate over what and where to cut, so too is there a great debate about whether and how much America should remain engaged and lead in the world.

We believe strongly that international engagement is in American's economic and national security interests.

There are three key elements in economic engagement: promoting open markets and free trade, promoting economic reform and development in the developing and transitioning nations, and leading in dealing with problems in global markets that can undermine our economic and national security interests.

There is a new isolationism afoot in this anxious age, and it must be aggressively countered. Recall if you will how difficult it was to get the trade treaties through Congress. Let me talk a moment about an issue you might not have considered recently, support for reform and growth in developing countries.

There is legislation on both sides of Capitol Hill which endangers the President's ability to conduct foreign affairs. Secretary Christopher, Secretary Perry, Ambassador Albright and I have recommended that the President veto any legislation of that nature. Those bills would harm our ability to support the reform and development efforts of the international financial institutions. That in turn would harm American businesses, restrict opportunities for exports, and undermine American jobs.

The World Bank, the development banks, and the IMF are playing a key role in promoting economic reform and economic growth, and our influence in these organizations, through the Treasury-appointed representatives on their boards, is enormous. As a result, the money we provide is highly leveraged, as is our impact on reform and development. Since its creation the World Bank has lent $130 to every $1 dollar the United States has put in and the international institutions encourage economic reform and political reforms that are in America's interests.

Forty percent of our exports go to developing countries -- that is about $190 billion a year -- and our largest and potential markets are developing countries like China and India.

Take the case of India -- a tremendous developing nation with a middle class roughly equivalent to the entire population of the United States. In 1991, with the assistance of the IMF, India began a dramatic economic transformation. It is reaching out to the world and changing within. The results are now obvious. India is growing, at about 5 percent last year, and our exports to India are rising.

The development programs of the World Bank are also making a difference in India. I visited a village in northwest India where the World Bank is supporting a watershed development project. With simple soil conservation techniques people who live in deep poverty are taking control of their lives, improving their living standards and making a better life for their children.

There is an extensive effort to assist in the transformation of the economies of eastern Europe and the former Soviet Union. I was in Russia and then Ukraine with President Clinton last month. I discussed with the Russian economic leadership the absolute need to stay focussed on privatizing and investment and trade -- through enforcing serious laws of contract, ensuring stockholders that their names won't vanish from stock registration books, opening up to foreign banks, and similar measures.

I can absolutely assure you that when I spoke to government officials and business people in Russia and Ukraine, they viewed the importance of the World Bank and the other development banks as critical to continued reform and economic growth. Reducing or eliminating their support is totally non-sensible in terms of our interests, but unfortunately on track in both houses.

Moreover, there is more to being engaged than negotiating trade agreements and encouraging development and economic reform.

The third element, as I mentioned, is dealing with the problems in global financial markets that threaten our economic interests and national security. That also takes leadership, the kind shown by the President in moving aggressively in our self-interest to assist Mexico and prevent a spill-over effect on other developing economies.

International engagement creates better jobs and better living standards for Americans. That's a message that needs spreading far and wide in this country, and I'm going to do my part in explaining how it will benefit Americans and American business at every opportunity.

So, those are two critical choices over the direction of the country which are being debated now in Washington and across the country. It is critical that our approach be to bring down the deficit, support education and other programs critical to positioning our economy for the long run, and engaging the global economy through trade, reform and development, and leadership in dealing with the problems of the global financial markets.

There is a third area where Americans are anxious and feel insecure, and feel alienation and anger: crime. And despite the seeming agreement on law and order, there are powerful forces at work undermining the federal law enforcement effort and this must be forcefully condemned.

Crime -- from handgun violence to drugs, from counterfeiting and fraud to money laundering -- takes not just an emotional toll on this country, but a tremendous financial toll as well. Look at it in terms of the needless hospital bills, the cost of prisons, the bill for security guards for employees. Look at it in terms of children at risk from drugs. Look at it in terms of additional costs and burdens on our businesses and financial institutions. All of this is a cost that puts us at a productivity disadvantage relative to many nations which do not have similar problems.

I knew about the financial and policy side of Treasury's work, and its reputation for excellence, well before I ever went into the Treasury Building. In the past five months I've also learned a great deal about the law enforcement side of Treasury's portfolio. We have the second largest law enforcement operation in the federal government, including the Secret Service, the Customs Service, the Bureau of Alcohol, Tobacco and Firearms, the enforcement side of the IRS, and our Financial Crimes Enforcement Network, and our Federal Law Enforcement Training Center.

Law enforcement is now being undermined in a very dangerous way, and it is deeply troubling that some have even suggested that the Oklahoma City terrorist bombing is somehow justified by Waco or other matters. I went to the memorial service for those killed in the Oklahoma City bombing and met with the families of the eight Secret Service and Customs employees who were killed there. Any attempt to link that bombing with any alleged justification is outrageous, but that link has gained at least some resonance even beyond fringe extremists. That resonance is grounded in the alienation and anger I've already discussed that too many Americans feel. Moreover, law enforcement officers are being portrayed as representatives of an oppressive federal government -- especially in the effort to control guns, to repeal the ban on semi-automatic assault weapons, and to oppose requiring explosive materials to contain identifying information that would facilitate identification of terrorists.

The ATF particularly has come under attack. I will tell you that the ATF deals with some of the most dangerous criminals in America -- the people who possess and are fully ready to use illegal firearms. All federal law enforcement officers have difficult and dangerous jobs and they need our support and respect. When there are problems, as there inevitably will be in any organization,... especially organizations where the jobs themselves are so dangerous, those problems should and will be addressed, but none of that should detract from the overriding importance of support and respect for people whose difficult and dangerous jobs are central to protecting the rest of us.

In conclusion, I have outlined the approaches I believe we must take with respect to the three critically important debates, if our economy and our nation are to be healthy in the 21st Century.

The Treasury is deeply involved in each of these areas, and we are doing everything within our power to advance the objectives I have advocated this evening, but every voice must be heard as these critical decisions are made. All of you here tonight are highly influential and can have a real impact on the outcome of these struggles. There is too much at stake in the future of our country for anyone who can have an effect to remain silent. So I would urge that each of you here this evening determine how you can help by supporting local candidates, by working with media people you know, by speaking in public forums, and in any other way available to you.

Thank you.

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June 5, 1995

Contract: Scott Dykema
(202) 622-2960

U.S., IRELAND TO NEGOTIATE NEW TAX TREATY

The United States and Ireland have agreed to negotiate a new income tax treaty, the Treasury Department said Monday.

A first round of talks is scheduled for the week of July 24, 1995 in Dublin.

The current treaty was signed in 1949 and is one of the oldest U.S. tax treaties still in force. The new treaty likely will better reflect current tax policies of the two countries, including rates of withholding tax and mutual agreement procedures under which tax authorities can resolve cases of double taxation.

Interested persons are invited to send comments to: the Department of the Treasury, Office of the International Tax Counsel, Room 3064, 1500 Pennsylvania Ave., N.W., Washington, D.C. 20220.

-30-

RR-342

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FOR IMMEDIATE RELEASE
June 5, 1995

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RUBIN REPORTS U.S. FIRMS BENEFIT FROM MDB CONTRACTS

Treasury Secretary Robert Rubin said on Monday that a Treasury report confirms that U.S. firms benefit greatly from contracts awarded by the Multilateral Development Banks (MDBs).

"U.S. participation in the development banks serves our political and security interests; it helps increase U.S. exports and create U.S. jobs," Secretary Rubin said.

The Treasury report, "The Multilateral Development Banks: Increasing U.S. Exports and Creating U.S. Jobs," outlines the important role that the development banks have played in building major new markets for U.S. exports in Asia, Africa and Latin America. It also emphasizes ground breaking private sector initiatives that the development banks have undertaken in Central and Eastern Europe. The report includes a state-by-state listing of MDB transactions broken out by city and specific firms.

"The important role the development banks play in developing and expanding markets should be key to congressional deliberations on providing funding for these vital institutions," Secretary Rubin said.

Secretary Rubin emphasized that developing countries are now the most rapidly expanding U.S. export market and that all indications are that economic growth will continue to accelerate in these countries over the next decade.

"We live in an increasingly interconnected world of more than 5.5 billion people. Because of the development banks, a great many of these people are increasing their incomes and becoming better customers for American goods and services," Secretary Rubin said.

The MDBs include the World Bank, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank and the European Bank for Reconstruction and Development.

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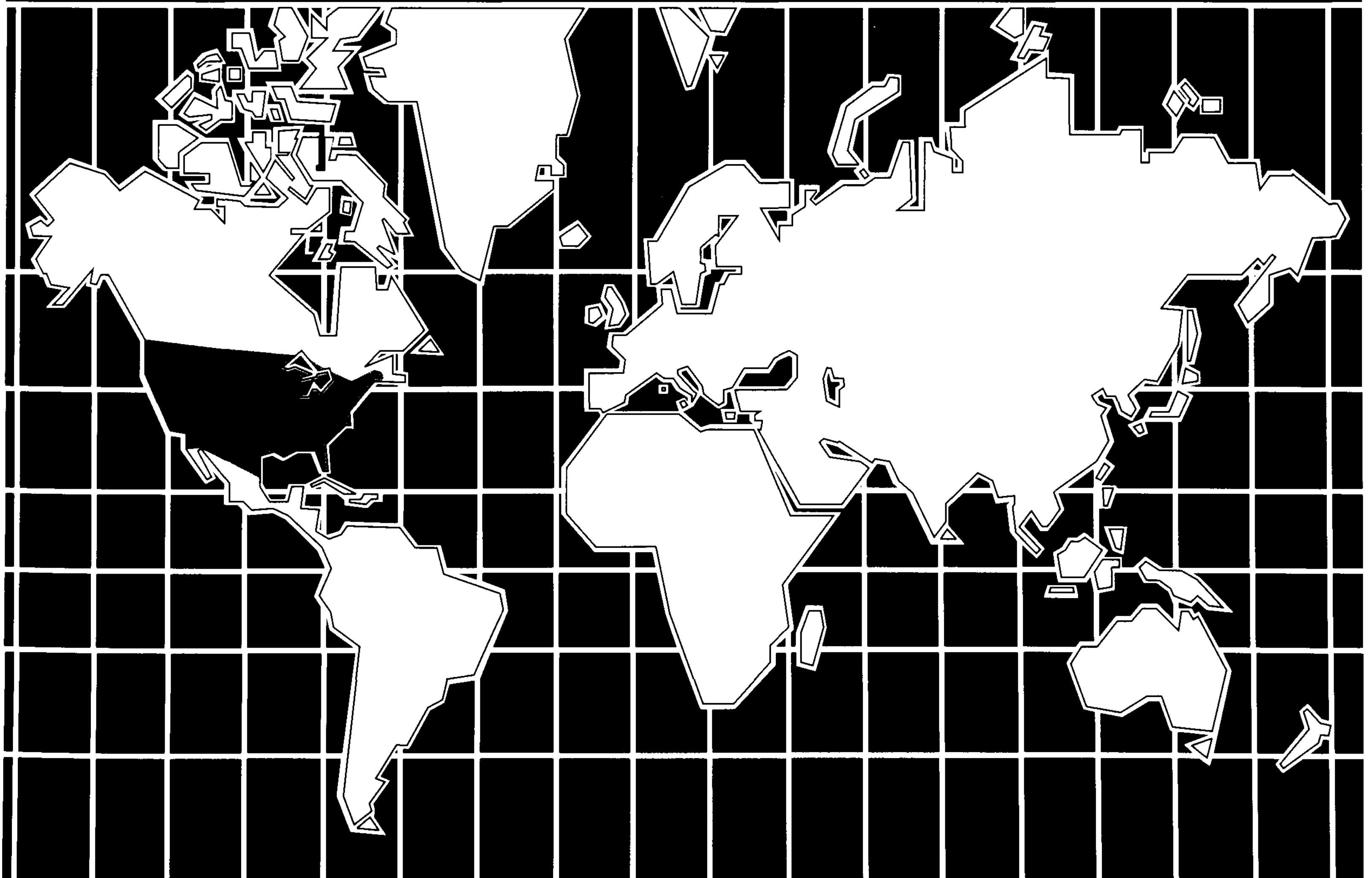
The Multilateral Development Banks:

Increasing U.S. Exports and Creating U.S. Jobs



The Multilateral Development Banks

Increasing U.S. Exports

and Creating U.S. Jobs

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Washington, D.C.
May 1995

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TABLE OF CONTENTS

PART I THE MULTILATERAL DEVELOPMENT BANKS INCREASING U.S. EXPORTS AND CREATING U.S. JOBS 1

PART II STATE-BY-STATE LISTING OF U.S. FIRMS 13

Alabama 17
Arizona 19
Arkansas 20
California 21
Colorado 34
Connecticut 37
Delaware 40
District of Columbia 41
Florida 48
Georgia 63
Hawaii 67
Idaho 68
Illinois 69
Indiana 75
Iowa 76
Kansas 77
Kentucky 78
Louisiana 79
Maryland 81
Massachusetts 85
Michigan 91
Minnesota 93
Mississippi 95
Missouri 96
Nebraska 98
Nevada 99
New Hampshire 100
New Jersey 101
New Mexico 107
New York 108
North Carolina 124
Ohio 126
Oklahoma 131
Oregon 132
Pennsylvania 133
Puerto Rico 140
Rhode Island 141
South Carolina 142
Tennessee 144
Texas 145
Utah 158
Vermont 159

Virginia 160
Washington 166
West Virginia 167
Wisconsin 168
Undetermined 171

PART III INTERNATIONAL TRADE ADMINISTRATION 173

PART IV CONTACT LIST FOR U.S. AND FOREIGN COMMERCIAL SERVICE 177

PART V CONTACT LIST FOR MULTILATERAL DEVELOPMENT BANKS 191

PART I

THE MULTILATERAL DEVELOPMENT BANKS

INCREASING U.S. EXPORTS

AND CREATING U.S. JOBS

THE MULTILATERAL DEVELOPMENT BANKS

Increasing U.S. Exports and Creating U.S. Jobs

The multilateral development banks are playing a leading role in increasing U.S. exports and creating U.S. jobs. Over the past several years, exports have been responsible for generating between 40 and 50 percent of the real growth in U.S. gross domestic product.

The multilateral development banks have sparked groundbreaking private sector initiatives in Central and Eastern Europe. They are building major new markets for U.S. firms in Asia, Africa, and Latin America, and working to remove impediments to economic growth in developing countries.

This is an important U.S. export story.

This is an important U.S. export story. It begins with contracts won by U.S. firms to provide goods and services for a wide range of projects financed through the multilateral development banks. In the past two years, nearly $5.0 billion have gone to thousands of U.S. firms as a direct result of their participation in multilateral development bank funded projects.

U.S. firms also benefit from the work the development banks have done in creating a friendlier economic environment for the private sector in developing countries. U.S. firms have increased their participation in equity and loan investments sponsored by the development banks, and they are beginning to take advantage of newly-enhanced instruments such as partial loan guarantees.

U.S. Firms Win Major Contracts

Development Bank funds go to major corporations and smaller companies

U.S. firms have always been among the most important commercial beneficiaries of multilateral development bank lending. Funds from the development banks have gone to major U.S. corporations, including General Electric, General Motors, Motorola, IBM, AT&T, Allied Signal, Westinghouse and others. These large publicly-held firms have facilities in a number of different states and employ tens of thousands people. The work they get through the development banks and the follow-on work that is generated in developing counties have had a highly-positive impact on the performance of the U.S. economy.

A significant portion of development bank funding also goes to smaller companies. Many of these smaller firms are privately-held, with one or two plants and 200-300 employees. The work they get from the multilateral development banks is an important source of

Caterpillar gets $250 million in export sales each year

McDermott wins important contracts in China and India

income, and it makes a large contribution to employment in the communities where their facilities are located.

Caterpillar of Peoria, Illinois, estimates that it gets $250 million in export sales of construction equipment each year as a result of its participation in multilateral development bank projects. Development bank financing has been responsible for Caterpillar sales of $11.8 million in Indonesia, $10 million in Egypt, $10 million in Zimbabwe, and $7 million in Mongolia.

McDermott International of New Orleans, Louisiana, a manufacturer of power generation equipment and supplies, is another important participant in development bank lending. In the early 1990s, McDermott was the lead firm in an international consortium that developed the Oso off-shore oil condensate project for the World Bank in Nigeria.

In 1994, McDermott won another World Bank contract for $155 million to provide boilers for an electric power project in China. Earlier this year, a McDermott subsidiary won an Asian Development Bank contract for $220 million for a pipeline project in India.

The development bank contracts won by U.S. firms like Caterpillar and McDermott create high-paying jobs in the cities and towns in which these companies have plants and facilities. Positive economic effects also spread to thousands of other firms in hundreds of other communities around the nation through subcontracting and the award of additional contracts to other suppliers.

Subcontractors and Suppliers

IBM teams with smaller firms to win contracts in Thailand and Argentina

GE suppliers are "hidden" U.S exporters

Two multilateral development bank contracts recently awarded to the IBM Corporation of Armonk, New York, provided major economic benefits for a number of subcontractors in other states including Arkansas, Ohio and California. Teaming with these smaller firms, IBM was successful in entering new data networking and retrieval markets in Thailand and Argentina. It is now pursuing follow-on contracts that should result in additional commercial benefits.

General Electric, one of the largest recipients of multilateral development bank contracts, estimates that more than 60 percent of the value of its total exports are purchased from its U.S. suppliers. In 1992, these suppliers received $9.5 billion from the sales of their products to various GE divisions which exported final products to foreign markets.

The GE Power Systems Division buys $1.6 billion in intermediate goods and services from 4,670 suppliers in 50 states and the District of Columbia, incorporating them into an export program that covers many developing countries. These power generation suppliers and others like them are "the hidden exporters" of the United States. They have benefited significantly from their participation in the work of the multilateral development banks.

Building New Markets

The heart of development bank lending is the work that is done to improve economic management and promote economic policy reform in developing countries. This is the most valuable part of their work; it leads to greater growth in developing countries, building new markets and giving an important stimulus to U.S. exports.

The multilateral development banks are the only institutions engaged in this type of activity. Through a unique combination of loans and policy guidance, they have given the economies of developing countries greater strength and flexibility and enhanced the flow of international trade and investment. Once new economic management and policies are in place, many developing countries are able to expand their economic output and become better customers for a broad range of U.S. goods and services. Between 1987 and 1993, U.S. exports to developing countries more than doubled from $91 billion to $197 billion.

Doubling of U.S. exports could not have taken place without the development banks

Developing countries have become our most rapidly expanding external market, purchasing 40 percent of all U.S. exports. They are responsible for creating or sustaining nearly 4 million U.S. jobs each year. These increases in U.S. exports and the jobs they have generated could not have taken place without the multilateral development banks and the work they do in promoting economic reform.

IDA and India

The International Development Association (IDA), the concessional loan window of the World Bank Group, has been one of the leading players in promoting economic reform. Its work in the less developed countries has made it an essential element in the multilateral development bank system. It is difficult to see how the development bank system could continue to function effectively in the absence of IDA reform programs.

India provides an important example of how IDA reform programs have worked to the economic advantage of the United states, increasing export and investment opportunities for U.S. firms. Under IDA lending, beginning in 1991, India cut its maximum tariffs from 400 percent to 65 percent and liberalized its investment rules.

Motorola and IBM penetrate an economy once almost completely closed to them

Since then, the United States has become the largest foreign investor in this large and growing South Asian market. Major U.S. firms like Motorola and IBM are beginning to penetrate an economy which was once almost completely closed to them. U.S. exports to India went from $1.9 billion to $2.9 billion in one year and, late last year, Commerce Secretary Brown was able to announce new contracts for U.S. firms amounting to more than $7.0 billion.

Other Countries Under IDA Reform

Other countries successfully implementing IDA economic reform programs include Kenya, Uganda and Cote d'Ivoire in Africa. In 19 Sub-Saharan counties under IDA economic reform programs, gross domestic product increased at an average annual rate of 4.5 percent between 1988 and 1993.

In other Sub-Saharan countries not under IDA economic reform, gross domestic product actually declined over that same period. IDA economic reforms work, and they work to the economic advantage of the United States. In Africa and elsewhere, these programs are beginning to build future markets for U.S. exports.

IDA has 20 graduates, including some of the largest and most important emerging markets for U.S. exports such as Korea, Indonesia, Thailand and Turkey. In 1993, these countries purchased $42 billion in U.S. exports and current IDA borrowers took an additional $20 billion.

Private Sector Is Key

Support for the private sector is the key to economic growth for developing countries and countries in transition in Central and Eastern Europe and the former Soviet Union. U.S. policy has strongly encouraged a friendlier environment for private business in developing and transition countries.

We have also sought to increase development bank support for a strong and sustained flow of private resources to these countries. We believe it is the most important contribution we can make to their economic progress.

IDA lends $1.6 billion per year to support private sector

Between 1988 and 1993, IDA's average annual lending in support of more favorable and competitive business environments in developing countries was $1.6 billion. That was nearly 30 percent of its total lending over that period. Leverage from IDA's investment operations in agriculture, mining, energy and the industrial sectors was used to identify and help overcome a number of specific obstacles to private investment.

This U.S. policy is showing results. Privatization programs are going forward quickly in Central and Eastern Europe and in many parts of the former Soviet Union. Developing countries have been cutting red tape, opening the doors to their markets to U.S. firms for the first time. A growing number of U.S. firms are benefiting from the increasing multilateral development bank support for free markets and private sector initiatives and participating in joint ventures.

Support for Private Sector Grows

In 1994, more than $1.7 billion, 73 percent of the loans from the European Bank for Reconstruction and Development, went to the private sector. The Bank also increased its equity investments in borrowing

countries and the financing it provides to local entrepreneurs through financial intermediaries there.

European Bank works with US West on telecommunications in Hungary

The European Bank is working with US West International of Denver, Colorado, to finance an $80 million telecommunications project in Hungary. It is also joining with Coca-Cola of Atlanta, Georgia, to provide financial support for a bottling plant in Albania.

Private sector programs are going forward rapidly in other parts of the world. In 1994, the International Finance Corporation (IFC), the private sector arm of the World Bank Group, made loan and equity investments of $2.5 billion. These investments supported 231 projects in 65 developing countries.

An additional $1.8 billion was raised through the IFC's loan syndication program and underwriting activities. The total value of the operations receiving support through the IFC was $18.5 billion.

IFC and AT&T cooperate on joint venture in Sri Lanka

The IFC is cooperating with AT&T on a joint venture to set up a cellular phone system in Sri Lanka. It is working with Sprint to improve telephone exchanges in Poland and it has joined with Tenet Healthcare Corporation of Santa Monica, California in constructing and equipping a 530 bed private hospital project in Bangkok, Thailand.

The World Bank and the Asian Development Bank are extending their guarantee programs to promote private sector participation in the expansion and replacement of infrastructure in Asia and Latin America. These new programs, which began in 1994 and 1995, provide partial guarantees for policy and credit risk.

Westinghouse gets credit guarantee from the World Bank

Thus far, the World Bank has extended a partial risk guarantee for a power project in Pakistan and two partial credit guarantees for projects in China and the Philippines. It was under one of these partial credit guarantees, that Westinghouse Corporation of Pittsburgh, Pennsylvania won a $155 million contract to supply turbines for a power project in China. U.S. firms should get additional benefits in the future as a result of new co-financing and guarantee programs now being put into place in the development banks.

Opportunities In Infrastructure

The growing need for physical infrastructure in developing countries is creating new export opportunities for many U.S. companies. With rising population pressures and rapid economic growth, developing countries are investing more than $200 billion each year in infrastructure. The need is greater because older systems have become overloaded and much of the infrastructure constructed in the 1960's is now wearing out and must be replaced.

The growth in demand for electric power has been particularly strong in larger countries like China, India, and Indonesia; but other developing countries also face very critical shortages of energy. Demand is accelerating for telecommunications, potable water, sanitation and sewerage, solid waste collection and disposal, and piped gas. Require-

ments are also rising rapidly for other traditional civil works such as urban and rural roads, dams and canal works, railways, ports, waterways and airports.

Cost of new infrastructure in Asia to be more than $1.0 trillion

In Asia alone, before the end of the decade, the cost of new physical infrastructure is expected to be more than $1.0 trillion. This market presents an unparalleled opportunity for U.S. firms, and they are well-positioned to take advantage of it. They have done very well in the past in getting a number of large contracts for important infrastructure work through development bank financing. They will also benefit from the work the development banks have done in promoting domestic capital markets in their borrowing countries and in encouraging deregulation and changes in pricing policies and rules of competition for public utilities.

ENRON does BOT project for ADB in Philippines

Many developing countries are entering into new arrangements with private companies including build, operate and transfer or BOT agreements. The Enron Corporation of Houston, Texas did the first BOT power project in Batangas, Philippines, through the Asian Development Bank's private sector window. This introduction by the Bank led to a second BOT agreement for Enron in the Philippines.

Other Large Contracts

U.S. companies have been very successful in winning contracts to provide fertilizers for a large number of agricultural projects in South Asia funded through the Asian Development Bank and the World Bank. In 1992, the Cargill Corporation of Minneapolis, Minnesota, won a number of these contracts for projects in India, China and Bangladesh which totaled more than $20 million.

Phospate Chemicals Export Association exports more than $68 million

Seminole Corporation of Stamford, Connecticut (which was acquired by Cargill in 1993) won contracts worth more than $56 million in Bangladesh and Pakistan between 1990 and 1994. Over the same period, the Phosphate Chemicals Export Association (which includes Occidental Chemical Company, Texas Gulf, and IMC Global) exported more than $68 million in fertilizers for projects in Pakistan and Bangladesh.

U.S. firms have received more contracts from the multilateral development banks than any other member country. In addition to the corporations already cited, they include Foster Wheeler, Dresser Rand, Halliburton/Brown and Root, and Deere and Company.

Sun Microsystems gets winning bid for computer project

A major contract went to Sun Microsystems of Mountain View, California which participated in a winning bid of $34 million for a tax computerization project in the Philippines. MW Kellogg of Houston, Texas is receiving disbursements on a $190 million contract it won in 1991 for a fertilizer facility in East Java in Indonesia.

Small and Medium-Size Firms

Small and medium-size firms also benefit from multilateral development bank business. American Cast Iron Pipe, a company with 3000 employee-owners in Birmingham, Alabama, is providing pipe and fittings for clean water and sewerage projects in Latin America and the Caribbean. These projects are funded through the World Bank and the Inter-American Development Bank.

American Cast Iron Pipe gets clean water projects in Latin America

Morrison Textile Machinery Company, which employs 135 people in Fort Lawn, South Carolina, has won contracts to provide bleaching and other equipment for industrial projects in India funded through the World Bank and the International Development Association. M&W Pump Corporation, which employs 200 people in Deerfield Beach, Florida, is providing fluid pumps and motors for other development bank-funded projects in Latin America and Asia.

Morrison Textiles wins contracts for industrial projects in India

Rising Demand For Services

A great deal of development bank work has gone to U.S. firms that provide specialized services such as consulting engineers, accounting firms, legal firms, and firms which provide financial and merchant banking expertise. Commercial banks, insurers, and freight forwarders also benefit. International trade in services like these and others is projected to rise very rapidly.

U.S. consulting and engineering firms have been in the forefront of many projects in developing countries that are funded through the multilateral development banks. They become involved at the earlier stages of the project cycle for major infrastructure projects, preparing feasibility and pre-feasibility studies, final designs and bid documents. They may also supervise implementation of the project on behalf of the borrower.

Wilbur Smith Associates of Columbia, South Carolina is developing a long-term strategy for expansion of Thailand's road network over the next 20 years that is being financed through the World Bank. This firm has just completed a traffic management study for Sierra Leone and is providing technical assistance through IDA for highway maintenance in Ghana and rehabilitation of transportation systems in Angola.

Wilbur Smith develops road network strategy in Thailand

Louis Berger of East Orange, New Jersey wrote the final designs and is now supervising construction of a Hungarian toll road project which is being funded through the European Bank for Reconstruction and Development. Berger has just completed preparatory work on the Buenos Aires-Colonia toll bridge project which will link Argentina and Uruguay. This project, which is expected to total $1.0 billion, is being funded through the International Finance Corporation and a number of private sector partners.

Louis Berger completes preparatory work on toll bridge in Argentina

Other engineering consultants benefiting from development bank work over the past several years include Morrison-Knudsen of San

Francisco, California; Black and Veatch of Kansas City, Missouri; Harza Engineering of Chicago, Illinois; Stanley Associates of Muscatine, Iowa; and De Leuw, Cather of Washington D.C. U.S. consultants won $257 million in contracts from the World Bank and IDA over the past two years.

Developing Countries Are Fastest Growing Markets

Market-oriented economies will be more open to U.S. trade and investment

In emphasizing the importance of free markets and the private sector, the development banks are continuing to create the economic environment that is essential for greater growth in developing countries. This work will result in more open and market-oriented economies that will grow more rapidly in the future and be more receptive to U.S. trade and investment.

Eighty-five percent of the world's population now lives in developing countries, and some of these countries have achieved the highest economic growth rates in the world. The largest and most profitable new opportunities for U.S. trade and investment are among the developing countries. We should not back away from those opportunities and risk the loss of business that would result for U.S. firms.

Over the next ten years, developing countries as a group are projected to grow at almost twice the rate of the industrial countries. It has been estimated that their share of world output could increase to 25 percent by the year 2004.

Developing countries to grow at twice the rate of industrial countries

Over this period, high-performing economies in East Asia are expected to lead the way with growth rates of 7.7 percent and the South Asian economies at around 5.4 percent. Even Sub-Saharan Africa, which is just beginning to improve its economic performance under IDA reform programs, is expected to grow by average annual rates of 3.8 percent over the next ten years.

By the year 2010, developing countries as a group could account for half of global consumption and half of global capital formation measured in purchasing power parity terms. By this measure, three of the developing countries — China, India, and Indonesia — could also be among the world's six largest economies.

Globalization Increases Opportunities

Integration of markets and the introduction of new technologies now permit capital to move rapidly from one market to another, increasing globalization of the world's economy. Developing countries are providing a major thrust for this process with their growing commitment to economic reform and initiatives promoted by the development banks that emphasize open markets and the role of the private sector. They are becoming more closely tied into the international economic system.

Implementation of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) and the North American Free Trade Agreement (NAFTA) is giving particular impetus to the acceleration of international trade and investment. Over the next decade, the growth in merchandise trade is expected to average 6 percent annually.

Growth in merchandise trade to average 6 percent annually

The developing countries' merchandise trade is expected to rise by more than seven percent over that same period. This increase in trade will present new opportunities for U.S. firms as they seek to consolidate their share of established markets and secure footholds in new markets. How U.S. firms are able to relate to the work of the development banks will be one of the principal determinants of success in the developing country markets.

Cost-Effective Internationalism

With international economic interests coming to the forefront of U.S. foreign policy concerns, and at a time of very severe budgetary constraint, the development banks are assuming greater importance. They are highly leveraged and cost-effective examples of international cooperation, providing important benefits to the U.S. economy.

Development banks raise almost all funds for ordinary capital from private capital markets

Each year, the development banks mobilize four dollars from other member countries for each dollar that we contribute. Most of that money comes from Europe and Japan. In addition, the development banks raise almost all their funds for ordinary capital lending from the world's private capital markets.

These two factors give the development banks the capability to lend a large multiple of the U.S. contribution. They lower the budgetary cost of our participation in the banks substantially every year.

U.S. Commercial Interests

We live in an increasingly interconnected world of more than 5.5 billion people. The great majority of those people —more than 85 percent — live in developing countries. Thanks to the work of the multilateral development banks, many people in developing countries have increased their incomes in recent years. They have become better customers for a broad range of goods and services that our country produces for export. U.S. firms need to remain engaged in their markets.

All indications are that economic growth will continue to accelerate in developing countries over the next decade. U.S. firms are competitive internationally. They have an important opportunity to build on the commercial gains they are already making in developing countries and begin to develop new trade and investment opportunities there.

Access to finance is essential if U.S. firms are to compete successfully

Access to finance is essential if U.S. firms are to compete successfully for trade and investment opportunities in developing countries. It would be a serious mistake to close them off from the resources of the multilateral development banks — one of the largest and most important sources of finance now available for U.S. firms doing business internationally.

U.S. participation in the development banks is an investment in our country's economic future. The returns from that investment will be increasing U.S. exports to developing countries, resulting in more high-paying export-related jobs and a higher standard of living for our people here at home. We cannot afford to walk away from the development banks and the economic opportunities they make possible.

PART II

STATE-BY-STATE LISTING

U.S. FIRMS

AND

CONTRACTS FROM

THE MULTILATERAL DEVELOPMENT BANKS

THE MULTILATERAL DEVELOPMENT BANKS

Part II of this report is a list of U.S. firms or individuals that have won contracts or received disbursements from the multilateral development banks. The list also includes entries for U.S. firms that have participated in equity or loan transactions to promote private sector activities in the work of the multilateral development banks over the last several years. The list is based on information generated by the development banks through their internal procurement reporting systems and made available for inclusion in this report.

This list is not complete; only a portion of the data on contracts, disbursements and other transactions has been identified in the report. Treasury has been working closely with all of the development banks to improve the effectiveness of their internal reporting systems, seeking to assure that the procurement information provided in the report is as complete and accurate as possible.

The multilateral development banks from which we have received information are:

IBRD	The International Bank for Reconstruction and Development (IBRD) or World Bank lends money for projects and programs in developing countries worldwide at market-related rates of interest. In its most recent fiscal year it made loans of just under $17 billion.
IDA	The International Development Association (IDA), part of the World Bank Group, lends money at concessional rates of interest to the world's poorest and least credit-worthy countries. In its most recent fiscal year it made loans of $7.8 billion.
IFC	The International Finance Corporation, the World Bank's private sector affiliate, offers loan and equity financing in support of private sector projects at market rates. During fiscal year 1994, the IFC offered $2.5 billion in new financing in support of 231 projects valued at $15.8 billion.
MIGA	The Multilateral Investment Guarantee Facility, part of the World Bank, offers investment insurance for non-commercial risks in developing countries. During fiscal year 1994, MIGA wrote new insurance contracts of $373 million dollars in support of $1.3 billion in investment in developing countries.
IDB	The Inter-American Development Bank (IDB) makes loans at market-related rates of interest to higher income and more credit-worthy developing member countries in Latin America and the Caribbean. In 1994, the Bank approved $5.5 billion in loans of this type and about $500 million in loans to poorer counties in the region at concessional rates of interest from its Fund for Special Operations (FSO).
IIC	The Inter-American Investment Corporation, the IDB's private sector affiliate, offers loan and equity financing in support of small private sector projects at market rates. During fiscal year 1994, the IIC offered $40 million in new financing.

ADB	The Asian Development Bank (ADB) makes loans at market-related rates of interest to borrowing member countries in the Asian and Pacific region. In 1994, the Bank approved $2.5 billion in loans at market rates.
ADF	The Asian Development Fund (ADF), part of the Asian Development Bank, made $1.2 billion in loans at concessional rates of interest to poorer borrowing member countries in the Asian region.
EBRD	The European Bank for Reconstruction and Development (EBRD) takes equity positions and makes loans at market-related rates of interest in its operating countries in Central and Eastern Europe and in the former Soviet Union. In 1994, the Bank approved 91 operations of this type amounting to $2.4 billion, including $1.7 billion in the private sector.
AFDB	The African Development Bank makes loans at market-related rates of interest to member countries in Africa. It also lends at concessional rates of interest through the African Development Fund (AFDF).

ALABAMA

CITY	COMPANY	AMOUNT ($'000)	BANK
Alabama City	Courtaulds Fibers Inc.	128	IBRD/IDA
Birmingham	Altec Industries Inc.	20,700	IDB
Birmingham	Altec Industries Inc.	12,681	IBRD/IDA
Birmingham	Altec Industries Inc.	221	IDB
Birmingham	American Cast Iron Pipe Co.	12,566	IBRD/IDA
Birmingham	American Cast Iron Pipe Co.	840	IDB
Birmingham	American Cast Iron Pipe Co.	69	IBRD/IDA
Birmingham	American Cast Iron Pipe Co.	27	IBRD/IDA
Birmingham	Guzzler Manufacturing Inc.	366	IDB
Birmingham	PBR Hotel - BE&K - Radisson Int'l	12,000	EBRD
Birmingham	Project Management Consultants Inc.	387	IDB
Birmingham	Taylor Warton Inc.	1,319	IBRD/IDA
Birmingham	Teco Inc.- Southeast Division	156	IDB
Birmingham	Universal Electric Co.	243	IDB
Birmingham	Universal Electric Co.	119	IDB
Decatur	Wolverine Tube Inc.	468	IBRD/IDA
Huntsville	Intergraph Corp.	746	IBRD/IDA
Huntsville	Intergraph Corp.	510	IDB
Huntsville	Intergraph Corp.	290	IBRD/IDA
Huntsville	Intergraph Corp.	236	IDB
Huntsville	SCI Manufacturing	331	IBRD/IDA
Huntsville	Wyle Labs Science Services & System Group	3,705	IBRD/IDA

ALABAMA

CITY	COMPANY	AMOUNT ($'000)	BANK
Huntsville	Wyle Labs Science Services & System Group	791	IBRD/IDA
Huntsville	Wyle Labs Science Services & System Group	780	IBRD/IDA
La Batre	Ocean Marine Inc.	2,296	AFDB
Leeds	Anderson Products	981	ADB
Leeds	Anderson Products	30	IDB
Mobile	OPICO	495	IDB
Mobile	OPICO	99	IBRD/IDA
Mobile	OPICO	36	IBRD/IDA
Mobile	Undetermined	14	ADB
Montgomery	Kershaw USA	915	IBRD/IDA
Prattville	Continental Eagle Corp.	2,300	AFDB
Unspecified	A.W. Williams Inspection Co.	8	IBRD/IDA
Unspecified	Duncan Industries	35	IBRD/IDA
Unspecified	Hagen & Miller Chemicals	73	ADB
Unspecified	J. Grunblatt	54	IBRD/IDA
Unspecified	Undetermined	467	IBRD/IDA
Unspecified	Undetermined	13	IBRD/IDA
State Total		77,495	

ARIZONA

CITY	COMPANY	AMOUNT ($'000)	BANK
Phoenix	Huma Gro	67	IBRD/IDA
Tempe	Edib Kirdar Assoc.	200	IBRD/IDA
Tempe	Edib Kirdar Assoc.	100	IBRD/IDA
Tucson	Syntellect Inc.	83	IBRD/IDA
Unspecified	Undetermined	1,216	ADB
State Total		1,666	

ARKANSAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Fayetteville	James Moore	5	IDB
Fayetteville	University of Arkansas	87	IBRD/IDA
Morrilton	Winrock Int'l	617	IBRD/IDA
Morrilton	Winrock Int'l	100	IBRD/IDA
Unspecified	Robert Wheaton	50	IBRD/IDA
Unspecified	Rolf F.H. Bolt	116	IBRD/IDA
Unspecified	Siemens	334	IBRD/IDA
Unspecified	Undetermined	3,486	IBRD/IDA
State Total		4,795	

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Anaheim	Bermad Control Valves Inc.	374	IBRD/IDA
Anaheim	Budde Int'l Inc.	3,191	IBRD/IDA
Anaheim	Budde Int'l Inc.	150	IBRD/IDA
Anaheim	Budde Int'l Inc.	24	IBRD/IDA
Anaheim	Budde Int'l Inc.	2	IDB
Arcadia	Engineering Science Inc.	2,272	IBRD/IDA
Arcadia	Engineering Science Inc.	1,607	IBRD/IDA
Arcadia	Engineering Science Inc.	1,018	IBRD/IDA
Bakersfield	Pruett Industries Int'l	139	IBRD/IDA
Berkeley	B.G. Technologies	38	IDB
Berkeley	Sierra Misco Inc.	285	IBRD/IDA
Brawley	California Livestock Co.	1,679	IBRD/IDA
Burbank	PSI Telecommunications Inc.	509	ADB
Burbank	PSI Telecommunications Inc.	312	ADB
Burbank	PSI Telecommunications Inc.	201	ADB
Burbank	Shamrock Capital Investors II	5,200	EBRD
Carlsbad	Artecom	14	IDB
Cerritos	Yasesu	21	IDB
Chico	Summa Int'l Data Systems	191	IBRD/IDA
Circle Cerritos	Reliance Exports Int'l	631	IBRD/IDA
Concord	Yeary & Assoc. Inc.	322	IBRD/IDA
Coronado	W.H. Thompson	50	EBRD

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Coronado	W.H. Thompson	14	IBRD/IDA
Costa Mesa	Keith Companies	42	IDB
Cyprus	Golden Earth Corp.	318	IBRD/IDA
Davis	University of California	3	ADF
El Monte	Sparling Instruments	344	IDB
El Toro	Advance American Technology	208	IBRD/IDA
Escondido	Transworld Communication	586	IDB
Ewerville	Sybase	97	IDB
Exeter	Bowsmith Inc.	33	IDB
Freemont	Logittech Inc.	1	IDB
Fresno	Conti Cotton	147	IBRD/IDA
Fullerton	Beckman Instruments Inc.	66	IDB
Fullerton	Beckman Instruments Inc.	53	IDB
Hawthorne	Pipe Technology Inc.	90	IDB
Hayward	Edison Hubbard Corp.	7,116	IBRD/IDA
Hayward	Edison Hubbard Corp.	526	ADB
Hollywood	Advanced Semiconductor Inc.	309	IBRD/IDA
Hollywood	Advanced Semiconductor Inc.	247	IBRD/IDA
Hollywood	Advanced Semiconductor Inc.	27	IBRD/IDA
Huntington Park	Trico Industries Inc.	182	ADB
Huntington Park	Trico Industries Inc.	91	IBRD/IDA
Inglewood	American Leina Co.	199	IBRD/IDA

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Invisie	Parmelex Inc.	394	IBRD/IDA
Irvine	Advance Logic Research	53	IDB
Irvine	Advance Logic Research	38	IDB
Irvine	AST Research Inc.	25	AFDB
Irvine	Astron Corp.	32	IDB
Irvine	Crown Pacific Int'l Inc.	2,567	IBRD/IDA
Irvine	Fluor Daniel Inc.	58	IBRD/IDA
Irvine	Toshiba American Information	4	IDB
Lafayette	Swanson & Oswald Assoc.	160	IBRD/IDA
Lafayette	Swanson & Oswald Assoc.	92	IBRD/IDA
Lafayette	Swanson & Oswald Assoc.	46	IBRD/IDA
Laguna Hills	LCP Int'l Institute	1,536	IBRD/IDA
Laguna Hills	LCP Int'l Institute	503	IBRD/IDA
Laguna Hills	LCP Int'l Institute	42	IBRD/IDA
Larkspur	Agland Investment Services Inc.	42	IDB
Larkspur	Agland Investment Services Inc.	13	IIC
Larkspur	Agland Investment Services Inc.	10	IIC
Livermore	PMC Engineering Co.	98	IDB
Long Beach	Astrophysics Research	466	IDB
Long Beach	BWIP Pump Int'l Inc.	7,235	IBRD/IDA
Long Beach	BWIP Pump Int'l Inc.	79	IDB
Long Beach	Kalibur Inc.	126	IBRD/IDA

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Long Beach	Pacific Valves Inc.	214	IBRD/IDA
Long Beach	V.E. Kuster Co.	165	ADB
Long Beach	V.E. Kuster Co.	162	IBRD/IDA
Long Beach	V.E. Kuster Co.	38	IDB
Los Angeles	Arthur Anderson & Co.	828	ADB
Los Angeles	Booz, Allen & Hamilton Inc.	1,531	IBRD/IDA
Los Angeles	Chevron Chemical Co.	4,270	IBRD/IDA
Los Angeles	Dames & Moore	515	IDB
Los Angeles	Dokken Engineering Co.	1,913	IBRD/IDA
Los Angeles	Eagle Packaging Group	129	IBRD/IDA
Los Angeles	Edison Hubbard Corp.	7,302	IBRD/IDA
Los Angeles	Edison Hubbard Corp.	5,093	IBRD/IDA
Los Angeles	Golden West Nuts Inc.	98	IBRD/IDA
Los Angeles	Grad Inc.	819	IBRD/IDA
Los Angeles	Institute for Tax Administration	28	AFDB
Los Angeles	Int'l Computer & Communication	132	IBRD/IDA
Los Angeles	J.R. Scheidner & Co.	333	IBRD/IDA
Los Angeles	L.A. Gear Inc.	1,237	IBRD/IDA
Los Angeles	Marketex Computer Corp.	285	IBRD/IDA
Los Angeles	Maypo Pump Corp.	96	IDB
Los Angeles	Shita Electric Ind. Co.	130	IBRD/IDA
Los Angeles	Silicon Graphics	889	IBRD/IDA

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Los Angeles	Silicon Graphics	389	IBRD/IDA
Los Angeles	Silicon Graphics	215	IBRD/IDA
Los Angeles	Tandem Computer Inc.	1,867	IBRD/IDA
Los Angeles	Time Warner	20,000	EBRD
Los Angeles	United States Borax & Chemical Corp.	223	IBRD/IDA
Los Angeles	University of California	342	IBRD/IDA
Los Angeles	University of Southern California	30	IBRD/IDA
Martinez	Walker Associates	105	IBRD/IDA
Martinez	Walker Associates	36	IBRD/IDA
Menlo Park	Barrett Consulting Group	449	ADB
Menlo Park	Stanford Research Institute Int'l	3,852	IBRD/IDA
Menlo Park	Stanford Research Institute Int'l	2,753	IBRD/IDA
Menlo Park	Stanford Research Institute Int'l	1,555	IBRD/IDA
Menlo Park	Stanford Research Institute Int'l	339	IBRD/IDA
Milpitas	Int'l Imaging Systems	323	IBRD/IDA
Mission Viejo	Inventors Int'l	74	ADB
Montebello	Peerless Pump	781	IBRD/IDA
Monterey Park	Sida Corp.	980	ADB
Monterey Park	Sida Corp.	475	IBRD/IDA
Mountain View	Maromatic Co.	158	IBRD/IDA
Mountain View	Sun Microsystems	500	IBRD/IDA
Mountain View	Sun Microsystems	399	IBRD/IDA

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Mountain View	Sun Microsystems	129	IDB
Napa	Napa Pipe Corp.	43,580	ADB
National City	Medosa Inc.	330	IBRD/IDA
Northridge	JBL Int'l	160	IDB
Novato	Envirocare Int'l	220	IBRD/IDA
Oakland	California Int'l Trade & Consult. Co.	1,679	IBRD/IDA
Orange	Systems Integrated Int'l	2,674	IBRD/IDA
Orange	Systems Integrated Int'l	1,394	IBRD/IDA
Orange	Systems Integrated Int'l	201	IBRD/IDA
Orange	Varco Int'l	2,176	IBRD/IDA
Palo Alto	Asset Management Co.	10,000	EBRD
Palo Alto	Chemtex Int'l Inc.	410	IBRD/IDA
Palo Alto	Hewlett Packard Co.	1,024	IBRD/IDA
Palo Alto	Hewlett Packard Co.	387	IBRD/IDA
Palo Alto	Hewlett Packard Co.	100	IBRD/IDA
Palo Alto	Stefan Weiss	4	IDB
Palo Alto	Valtex Int'l Corp.	785	EBRD
Palo Alto	Valtex Int'l Corp.	393	IBRD/IDA
Palo Alto	Valtex Int'l Corp.	224	IBRD/IDA
Palo Alto	Varian Associates Inc.	562	IBRD/IDA
Palo Alto	Varian Associates Inc.	223	IBRD/IDA
Palo Alto	Varian Associates Inc.	146	IBRD/IDA

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Pasadena	Engineering Science Inc.	1,443	IBRD/IDA
Pasadena	Engineering Science Inc.	1,369	ADB
Pasadena	Engineering Science Inc.	1,165	ADF
Pasadena	Engineering Science Inc.	645	ADF
Pasadena	Engineering Science Inc.	640	ADF
Pasadena	Engineering Science Inc.	590	ADB
Pasadena	Engineering Science Inc.	122	ADF
Pasadena	Engineering Science Inc.	56	IBRD/IDA
Pasadena	Jacobs Engineering Group Inc.	56	IIC
Pasadena	James M. Montgomery Consulting	652	IBRD/IDA
Pasadena	James M. Montgomery Consulting	458	IBRD/IDA
Pasadena	James M. Montgomery Consulting	214	IBRD/IDA
Pasadena	James M. Montgomery Consulting	147	IBRD/IDA
Pasadena	Kinemetrics Inc.	376	IBRD/IDA
Pasadena	Kinemetrics Inc.	354	IBRD/IDA
Pleasanton	Computerland Corp.	151	IBRD/IDA
Redwood City	Fluor Daniel Inc.	124	IBRD/IDA
Redwood Shores	Oracle Corp.	25	IDB
Richmond	Geothermex Inc.	1,545	IDB
Richmond	Geothermex Inc.	1,545	IDB
Riverside	Bear Medical Systems Inc	137	IDB
Rocklin	Hewlett Packard Co.	248	IBRD/IDA

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Rosemead	United Manda Inc.	254	IBRD/IDA
Sacramento	Dokken Engineering Co.	1,913	IBRD/IDA
Sacramento	Dokken Engineering Co.	1,203	IBRD/IDA
Sacramento	Ebara Int'l Corp.	1,926	IBRD/IDA
San Diego	Gamma-Metrics	601	IBRD/IDA
San Diego	Grabil Int'l	180	IBRD/IDA
San Diego	Humphrey Inc.	374	IBRD/IDA
San Diego	IVAC Corp.	43	IDB
San Diego	Solar Turbines Int'l	5,977	IBRD/IDA
San Diego	Solar Turbines Int'l	3,045	IBRD/IDA
San Diego	Solar Turbines Int'l	2,276	IBRD/IDA
San Diego	Solar Turbines Int'l	417	IBRD/IDA
San Diego	Solar Turbines Int'l	172	IBRD/IDA
San Diego	Solar Turbines Int'l	35	IBRD/IDA
San Diego	Space Electronics Inc.	25	EBRD
San Francisco	Bank of America	27,500	IFC
San Francisco	Bechtel Int'l Inc.	2,742	IBRD/IDA
San Francisco	Bechtel Int'l Inc.	2,290	IBRD/IDA
San Francisco	Bechtel Int'l Inc.	2,252	IBRD/IDA
San Francisco	Bechtel Int'l Inc.	1,351	IBRD/IDA
San Francisco	Bechtel Int'l Inc.	1,124	IBRD/IDA
San Francisco	Bently Engineering Co.	40	IDB

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
San Francisco	BHP-Utah Minerals Inc.	763	IBRD/IDA
San Francisco	Capital Investment Group	900	EBRD
San Francisco	Century Bank	10	ADF
San Francisco	Century Bank	2	ADB
San Francisco	Century Bank	2	ADF
San Francisco	Century Bank	1	ADF
San Francisco	EQE Int'l Inc.	245	IBRD/IDA
San Francisco	EQE Int'l Inc.	241	IBRD/IDA
San Francisco	Geomatrix Consultants Inc.	666	IDB
San Francisco	Geomatrix Consultants Inc.	585	IBRD/IDA
San Francisco	Hambrecht & Quist Int'l	3,188	IFC
San Francisco	Manalytics Int'l	26	EBRD
San Francisco	Marubeni America Corp.	1,195	IBRD/IDA
San Francisco	Morrison-Knudsen Engineering Corp.	914	ADF
San Francisco	Morrison-Knudsen Engineering Corp.	861	ADF
San Francisco	Morrison-Knudsen Engineering Corp.	774	IBRD/IDA
San Francisco	Morrison-Knudsen Engineering Corp.	385	IBRD/IDA
San Francisco	Morrison-Knudsen Engineering Corp.	290	IBRD/IDA
San Francisco	Transcisco Trading Co.	1,007	IBRD/IDA
San Francisco	Transcisco Trading Co.	113	IBRD/IDA
San Francisco	Walden Group	7,500	IFC
San Francisco	Walden Group	10	IFC

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
San Jose	Dataquest Inc.	4	EBRD
San Jose	Digital Microwave Corp.	896	IBRD/IDA
San Jose	EPRO	136	IBRD/IDA
San Jose	Finnigan Materials	568	IBRD/IDA
San Jose	VLSI Technology Inc.	190	IBRD/IDA
San Juan	WYSE Technology	169	IDB
San Leandro	Cooper Lighting	288	IDB
San Pedro	Zuanich & Associates	13,000	IFC
Santa Barbara	Moseley Associates Inc.	5,653	ADB
Santa Cruz	Global Technology Inc.	524	IBRD/IDA
Santa Cruz	Global Technology Inc.	270	IBRD/IDA
Santa Cruz	Global Technology Inc.	38	IBRD/IDA
Santa Cruz	Menonita Development Associates	200	IDB
Santa Monica	National Medical Enterprises Inc.	27,240	IFC
Santa Monica	Rand Corp.	72	IDB
Simi Valley	Tandon Associates Inc.	363	IBRD/IDA
Stockton	California Cedar Products	114	IBRD/IDA
Stockton	Carando Machine Works	164	IBRD/IDA
Sun Valley	Astro Arc Co.	44	IDB
Sunnyvale	Ashtech Inc.	122	IDB
Sunnyvale	EG&G Int'l	359	IBRD/IDA
Sunnyvale	EG&G Int'l	109	IDB

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Sunnyvale	Handar Inc.	999	IBRD/IDA
Temecula	Enrique Herrera	9	IDB
Torrance	Epson American Inc.	2	IDB
Torrance	Laserionics	185	IDB
Torrance	Microtek Lab Inc.	2	IDB
Torrance	Ohra Corp.	3,190	IBRD/IDA
Torrance	Ohra Corp.	1,871	IBRD/IDA
Torrance	Ohra Corp.	208	IBRD/IDA
Torrance	Ohra Corp.	100	IBRD/IDA
Torrance	Telemobile	66	IDB
Torrance	Tylan General Inc.	5	IDB
Unspecified	Air Shields Vickers	354	IBRD/IDA
Unspecified	American Pipe & Construction Int'l	159	IBRD/IDA
Unspecified	Apple Computers Inc.	624	IBRD/IDA
Unspecified	Business Dynamics	41	IBRD/IDA
Unspecified	Chevron Chemicals Int'l	16,489	IBRD/IDA
Unspecified	Chevron Chemicals Int'l	822	IBRD/IDA
Unspecified	Chevron Chemicals Int'l	511	IBRD/IDA
Unspecified	Connell Bros. Co.	2,169	IBRD/IDA
Unspecified	Continental Field	4,550	IBRD/IDA
Unspecified	Dionex Corp.	110	IBRD/IDA
Unspecified	Donald Chauls	158	IBRD/IDA

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Donald Chauls	63	IBRD/IDA
Unspecified	Duong Kich Nhuong	85	IBRD/IDA
Unspecified	Enresa Group	16	IBRD/IDA
Unspecified	ESI-Nippon-Basic	533	IBRD/IDA
Unspecified	Futton Inc.	283	IBRD/IDA
Unspecified	Interbridge	259	IBRD/IDA
Unspecified	Jose Da Silva Goncalves	120	IBRD/IDA
Unspecified	Macro Computers	339	IBRD/IDA
Unspecified	Mahmood S. Suleiman	6	IBRD/IDA
Unspecified	Mayeusis-Field	822	IBRD/IDA
Unspecified	Michael D. Broten	71	IBRD/IDA
Unspecified	R.N. Seemel	110	IBRD/IDA
Unspecified	R.V. Santos	2,203	IBRD/IDA
Unspecified	Spar Communication Group	6,480	ADB
Unspecified	Star-Dynamic Int'l Inc.	1,995	IBRD/IDA
Unspecified	Stauffer Chemical Co.	107	IBRD/IDA
Unspecified	Stokes Engineering Co.	126	IBRD/IDA
Unspecified	S. Blaj	33	IBRD/IDA
Unspecified	Undetermined	27,496	IBRD/IDA
Unspecified	Well Head Inc.	607	ADB
Venice	Int'l Parts	219	IBRD/IDA
Woodside	Robert Trent Jones II	650	IIC

CALIFORNIA

CITY	COMPANY	AMOUNT ($'000)	BANK
State Total		384,651	

COLORADO

CITY	COMPANY	AMOUNT ($'000)	BANK
Arvada	Denver Instrument Co.	3	ADF
Arvada	Sundstrand Fluid Handling	238	IBRD/IDA
Boulder	Economics Institute	161	AFDB
Boulder	Gustavson Assoc.	171	IBRD/IDA
Boulder	Gustavson Assoc.	135	IBRD/IDA
Boulder	Gustavson Assoc.	27	IBRD/IDA
Boulder	Lighting Eliminators & Co.	304	IBRD/IDA
Boulder	Pedro J. Restrepo	52	IDB
Denver	Anderman Smith Overseas Inc.	40,000	EBRD
Denver	A.B. Wilflef & Sons	127	IBRD/IDA
Denver	Behre, Dolbear & Co.	69	EBRD
Denver	ECL-Bergeson Petroleum Technology	263	IBRD/IDA
Denver	ECL-Bergeson Petroleum Technology	158	IBRD/IDA
Denver	Intra Information Technologies	45	EBRD
Denver	Newmont Gold Co.	10,000	MIGA
Denver	Newmont Mining Corp.	55,000	EBRD
Denver	Newmont Mining Corp.	55,000	EBRD
Denver	United Int'l Holding	23,950	EBRD
Denver	United Int'l Holding	10,400	EBRD
Denver	US West Int'l	10,000	EBRD
Denver	US West Int'l	2,000	EBRD
Denver	U.S. Bureau of Reclamation	1,142	IBRD/IDA

COLORADO

CITY	COMPANY	AMOUNT ($'000)	BANK
Denver	U.S. Bureau of Reclamation	704	IBRD/IDA
Denver	U.S. Bureau of Reclamation	501	IBRD/IDA
Denver	U.S. Bureau of Reclamation	278	IBRD/IDA
Denver	U.S. Bureau of Reclamation	201	IBRD/IDA
Denver	U.S. Bureau of Reclamation	104	IBRD/IDA
Englewood	Advance Geophysical Corp.	112	IBRD/IDA
Englewood	Adventure Travel Society	37	IDB
Englewood	Air Drilling Services Inc.	2,444	ADB
Englewood	Air Drilling Services Inc.	2,444	IDB
Englewood	Air Drilling Services Inc.	1,481	IDB
Englewood	CH2M Hill Int'l Corp.	240	IBRD/IDA
Englewood	Cyprus Amax	52,500	EBRD
Englewood	Cyprus Climax Metals Co.	50,000	MIGA
Englewood	Minproc Eng. Inc.	215	IBRD/IDA
Englewood	US West Int'l	10,000	EBRD
Golden	Atlas Copco N.A.	62	IDB
Lakewood	Pincock, Allen & Holt	322	IBRD/IDA
Lakewood	Pincock, Allen & Holt	83	EBRD
Lakewood	Pincock, Allen & Holt	71	IBRD/IDA
Littletown	Harms Brady Geological Cons.	664	IBRD/IDA
Littletown	Harms Brady Geological Cons.	601	IBRD/IDA
Littletown	Terraplus USA Inc.	274	IBRD/IDA

COLORADO

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Donald Gentry	1	IBRD/IDA
Unspecified	Engineering Consultant Inc.	120	IBRD/IDA
Unspecified	Fred Barnard	19	IBRD/IDA
Unspecified	PRC Engineering Construction	207	IBRD/IDA
Unspecified	PRC Engineering Construction	205	IBRD/IDA
Unspecified	T.M. Taylor	34	IBRD/IDA
Unspecified	Undetermined	2,205	IBRD/IDA
Unspecified	Undetermined	462	ADB
State Total		335,836	

CONNECTICUT

CITY	COMPANY	AMOUNT ($'000)	BANK
Danbury	Union Carbide Interamerica	1,909	IBRD/IDA
Farmington	Aid to Artisans Inc.	26	IDB
Greenwich	CAM USA Inc.	4,399	AFDB
Greenwich	Nitron Int'l Corp.	743	IBRD/IDA
Greenwich	Pasternak, Baum & Co.	2,922	IBRD/IDA
Greenwich	Pasternak, Baum & Co.	245	IBRD/IDA
Greenwich	Pittston Coal Export Corp.	4,249	IBRD/IDA
Hartford	Aetna Life & Casualty	20,000	IFC
Hartford	America Natural Soda Ash Co.	630	IBRD/IDA
Hartford	Chemical Trading Inc.	1,149	IBRD/IDA
Hartford	Great Southern Paper	410	IBRD/IDA
Hartford	Miltemberg & Samton Inc.	2,000	IBRD/IDA
Middlebury	Uniroyal Chemical Co.	50	AFDB
Milford	BIC Corp.	670	IBRD/IDA
Milford	Dorr-Oliver Inc.	66	IBRD/IDA
Norfolk	Muehlstein Int'l	1,084	IBRD/IDA
Norfolk	Perkin-Elmer Corp.	632	IBRD/IDA
Norfolk	Perkin-Elmer Corp.	350	IBRD/IDA
Norfolk	Perkin-Elmer Corp.	153	IDB
Norfolk	Perkin-Elmer Corp.	102	IBRD/IDA
Norfolk	Perkin-Elmer Corp.	79	ADB
Norwalk	Hobbs Int'l	2,655	IDB

CONNECTICUT

CITY	COMPANY	AMOUNT ($'000)	BANK
Ridgefield	Dapco Industries	5,338	IBRD/IDA
Rocky Hill	Energy Maintenance Corp.	109	IBRD/IDA
Stamford	Clarendon	1,327	IBRD/IDA
Stamford	GTE Services Corp.	6,500	EBRD
Stamford	Int'l Executive Services Corp.	8	IIC
Stamford	Int'l Executive Services Corp.	8	IIC
Stamford	Irene Taafaki	132	ADF
Stamford	ITT Rayonier Inc.	326	IBRD/IDA
Stamford	Olin Corp.	6,500	IBRD/IDA
Stamford	Peabody Engineering Corp.	201	IDB
Stamford	Seminole Fertilizer Corp.	9,177	ADF
Stamford	Seminole Fertilizer Corp.	1,049	ADB
Storrs	University of Connecticut	17	ADB
Storrs	University of Connecticut	7	AFDB
Stratford	Dictaphone Corp.	42	IDB
Trumbull	Nash Int'l Co.	47	IIC
Unspecified	Griffiths Associates Inc.	134	IBRD/IDA
Unspecified	James Chemical Engineering Inc.	131	IBRD/IDA
Unspecified	Skaarup Oil Corp.	29	IBRD/IDA
Unspecified	Technoserve	216	IBRD/IDA
Unspecified	Undetermined	9,278	IBRD/IDA
Wallingford	Coronetrics Medical Systems	29	IDB

CONNECTICUT

CITY	COMPANY	AMOUNT ($'000)	BANK
Watertown	Paul Vonclx	21	EBRD
Weston	Stokes Engineering Co.	174	IBRD/IDA
Westport	America Natural Soda Ash Co.	695	IBRD/IDA
Westport	Phoenix Packaging Resources Inc.	8	IIC
Westport	Phoenix Packaging Resources Inc.	6	IIC
Wilton	Louis Dreyfus Corp.	2,315	IBRD/IDA
Wilton	Louis Dreyfus Corp.	2,146	IBRD/IDA
Windsor	Combustion Engineering Inc.	466	IBRD/IDA
State Total		90,959	

DELAWARE

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Undetermined	419	IBRD/IDA
Wilmington	Billion Corp.	38	IBRD/IDA
Wilmington	Booz, Allen & Hamilton Inc.	126	IBRD/IDA
Wilmington	Du Pont de Nemours	44,825	IFC
Wilmington	Du Pont de Nemours	2,277	IBRD/IDA
Wilmington	Du Pont de Nemours	380	IBRD/IDA
Wilmington	Du Pont de Nemours	337	IBRD/IDA
Wilmington	Du Pont de Nemours	236	IBRD/IDA
Wilmington	Himont Inc.	4,000	IFC
Wilmington	Medical Products	74	IDB
Wilmington	Nynex Network Systems Co.	607	IBRD/IDA
State Total		53,319	

WASHINGTON, D.C.

CITY	COMPANY	AMOUNT ($'000)	BANK
Arlington	Nathan Associates	119	IDB
Washington, DC	Academy for Educational Development Inc.	8	IDB
Washington, DC	ACDI	671	IBRD/IDA
Washington, DC	Aegis Capital Management, Ltd	60	ADB
Washington, DC	Amex Int'l Inc.	74	AFDB
Washington, DC	Amideast	188	IBRD/IDA
Washington, DC	Appropriate Technology Int'l	30	IDB
Washington, DC	Audre Engleman	107	IBRD/IDA
Washington, DC	Brownstein, Zeioman & Lore	18	IDB
Washington, DC	Bryan Cave	18	IBRD/IDA
Washington, DC	CARE Small Business Assistance	4,000	EBRD
Washington, DC	CARE Small Business Assistance	153	EBRD
Washington, DC	CARE Small Business Assistance	97	EBRD
Washington, DC	Carlos De Castro	47	IBRD/IDA
Washington, DC	Catherine Reid	6	IBRD/IDA
Washington, DC	CEELI	4	EBRD
Washington, DC	Checchi & Co.	332	AFDB
Washington, DC	Chemonics Int'l	2,009	ADB
Washington, DC	Chemonics Int'l	1,926	ADF
Washington, DC	Chemonics Int'l	1,168	ADF
Washington, DC	Chemonics Int'l	700	ADB
Washington, DC	Chemonics Int'l	14	IBRD/IDA

WASHINGTON, D.C.

CITY	COMPANY	AMOUNT ($'000)	BANK
Washington, DC	Clusa	52	IBRD/IDA
Washington, DC	Communities Group	15	IBRD/IDA
Washington, DC	Conservation Int'l	144	IBRD/IDA
Washington, DC	Cooperative Housing Foundation	50	IDB
Washington, DC	Coopers & Lybrand	37	IDB
Washington, DC	Coopers & Lybrand	14	IDB
Washington, DC	C. Polansky	9	IBRD/IDA
Washington, DC	De Leuw Cather Int'l	550	IBRD/IDA
Washington, DC	De Leuw Cather Int'l	200	IDB
Washington, DC	De Leuw Cather Int'l	148	IBRD/IDA
Washington, DC	De Leuw Cather Int'l	124	IBRD/IDA
Washington, DC	De Leuw Cather Int'l	79	IBRD/IDA
Washington, DC	Deloitte Touche Tohmatsu Int'l	341	IBRD/IDA
Washington, DC	Deloitte Touche Tohmatsu Int'l	52	IDB
Washington, DC	Deloitte Touche Tohmatsu Int'l	19	IDB
Washington, DC	Deloitte Touche Tohmatsu Int'l	11	IDB
Washington, DC	Devres Inc.	163	IBRD/IDA
Washington, DC	DMJM Int'l	211	ADB
Washington, DC	Dow, Lohnes & Albertson	83	IDB
Washington, DC	Earth Satellite Corp.	11	IDB
Washington, DC	Ernst & Young	148	IBRD/IDA
Washington, DC	Ernst & Young	88	IDB

WASHINGTON, D.C.

CITY	COMPANY	AMOUNT ($'000)	BANK
Washington, DC	Eugene Rotberg	11	EBRD
Washington, DC	Export Import Bank & unspecified U.S. banks	22,000	IFC
Washington, DC	Export Import Bank & unspecified U.S. banks	18,877	IFC
Washington, DC	Foster Wheeler Int'l Corp.	95	IBRD/IDA
Washington, DC	Georgetown University	513	IDB
Washington, DC	Georgetown University	29	IDB
Washington, DC	Hamilton, Rabinovitz & Alschuler Inc.	95	IDB
Washington, DC	Howrey & Simon	50	IDB
Washington, DC	Information for Investment Decisions	216	IDB
Washington, DC	Information for Investment Decisions	189	IDB
Washington, DC	Information for Investment Decisions	135	IDB
Washington, DC	Information for Investment Decisions	133	IDB
Washington, DC	Information for Investment Decisions	85	IDB
Washington, DC	Information for Investment Decisions	66	IDB
Washington, DC	Inter Connect Associates	1	IIC
Washington, DC	Int'l Center for Research for Women	56	IDB
Washington, DC	Int'l Center for Research on Women	51	IDB
Washington, DC	Int'l Center for Research on Women	51	IDB
Washington, DC	Int'l Food Policy Research Institute	48	IDB
Washington, DC	Int'l Road Federation	21	IBRD/IDA
Washington, DC	IO Consultants	5	IIC
Washington, DC	John Cleave	44	EBRD

WASHINGTON, D.C.

CITY	COMPANY	AMOUNT ($'000)	BANK
Washington, DC	J.M. Ruisanchez	92	IBRD/IDA
Washington, DC	Kessler Int'l Corp.	49	IBRD/IDA
Washington, DC	KPMG Peat Marwick	99	AFDB
Washington, DC	K&M Engineering & Consulting	4,471	EBRD
Washington, DC	Lauren Cooper Assoc.	56	IBRD/IDA
Washington, DC	Lem Truong	66	IBRD/IDA
Washington, DC	Louis Berger Int'l Inc.	4,761	IDB
Washington, DC	Louis Berger Int'l Inc.	3,153	ADB
Washington, DC	Louis Berger Int'l Inc.	2,883	IDB
Washington, DC	Louis Berger Int'l Inc.	2,379	IDB
Washington, DC	Louis Berger Int'l Inc.	2,008	IDB
Washington, DC	Louis Berger Int'l Inc.	1,940	IDB
Washington, DC	Louis Berger Int'l Inc.	1,940	IDB
Washington, DC	Louis Berger Int'l Inc.	914	IDB
Washington, DC	Louis Berger Int'l Inc.	790	IDB
Washington, DC	Louis Berger Int'l Inc.	396	IDB
Washington, DC	Management Systems Int'l	585	IBRD/IDA
Washington, DC	Management Systems Int'l	31	IDB
Washington, DC	Management Systems Int'l	25	IDB
Washington, DC	McCarthy Sweeney & Harkaway	425	IBRD/IDA
Washington, DC	Medical Care Development Inc.	800	AFDB
Washington, DC	Merrklein & Assoc.	60	IBRD/IDA

WASHINGTON, D.C.

CITY	COMPANY	AMOUNT ($'000)	BANK
Washington, DC	Miller & Holbrooke	24	IDB
Washington, DC	Moussa Kouruma	58	IBRD/IDA
Washington, DC	Mustafa Soykan	135	IBRD/IDA
Washington, DC	M. Chambers	108	IBRD/IDA
Washington, DC	National Academy of Science	85	IBRD/IDA
Washington, DC	National Rural Electrification Int'l Ltd	3	IBRD/IDA
Washington, DC	Overseas Private Inv. Corp & unspecified US banks	24,000	IFC
Washington, DC	PADCO	2,085	IDB
Washington, DC	PADCO	1,170	IDB
Washington, DC	PADCO	823	IDB
Washington, DC	PADCO	6	IDB
Washington, DC	Partnership for Productivity Int'l	493	IDB
Washington, DC	Planecon Inc.	10,655	EBRD
Washington, DC	Price Waterhouse Int'l	250	ADB
Washington, DC	Price Waterhouse Int'l	47	IBRD/IDA
Washington, DC	Private Sector Initiatives	17	IDB
Washington, DC	RCG Hagler Bailly Inc.	792	ADB
Washington, DC	Resource Industries Ltd	9	IBRD/IDA
Washington, DC	Rhea Corp.	48	IIC
Washington, DC	Ronald A. Schwarz	25	IBRD/IDA
Washington, DC	Seatec Int'l Ltd	222	ADB
Washington, DC	Smithsonian Institution	80	IDB

WASHINGTON, D.C.

CITY	COMPANY	AMOUNT ($'000)	BANK
Washington, DC	Socimer Int'l Inc.	224	IDB
Washington, DC	Socimer Int'l Inc.	10	IDB
Washington, DC	Socimer Int'l Inc.	5	IDB
Washington, DC	Steptoe & Johnson	49	IBRD/IDA
Washington, DC	Steptoe & Johnson	4	EBRD
Washington, DC	Teleconsult Inc.	858	AFDB
Washington, DC	Teleconsult Inc.	184	IBRD/IDA
Washington, DC	Teleconsult Inc.	39	EBRD
Washington, DC	Teleconsult Inc.	33	IIC
Washington, DC	Undetermined	7,726	IBRD/IDA
Washington, DC	Urban Institute	93	IDB
Washington, DC	Urban Institute	25	IDB
Washington, DC	Urban Institute	9	IDB
Washington, DC	U.S. Bureau of the Census	30	IDB
Washington, DC	U.S. Department of Agriculture	48	ADF
Washington, DC	U.S. Department of Agriculture	10	ADF
Washington, DC	U.S. Department of Agriculture - Graduate School	15	AFDB
Washington, DC	U.S. Internal Revenue Service	132	IDB
Washington, DC	U.S. National Park Service	2,321	EBRD
Washington, DC	Vincent G. Theel	11	ADF
Washington, DC	Washington Development Capital	39,215	EBRD
Washington, DC	World Wildlife Fund	63	IBRD/IDA

WASHINGTON, D.C.

CITY	COMPANY	AMOUNT ($'000)	BANK
Washington, DC	WTIG Investment Group	2	IIC
State Total		177,233	

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Alachua	Driltech Inc.	1,148	IBRD/IDA
Alachua	Driltech Inc.	120	AFDB
Boca Raton	American Equipment Co.	1,081	IBRD/IDA
Boca Raton	American Equipment Co.	800	IBRD/IDA
Boca Raton	American Equipment Co.	46	IBRD/IDA
Boca Raton	Dole Fresh Fruit Co.	249	IBRD/IDA
Boca Raton	Intergraph Corp.	236	IDB
Clermont	Philipps	39	IDB
Coral Gables	Alcoa Inter-America Inc.	3,305	IBRD/IDA
Coral Gables	Cargill Americas Inc.	2,073	IBRD/IDA
Coral Gables	Caribe General Electric Co.	61	IDB
Coral Gables	Crown Agents Services Ltd	23	IDB
Coral Gables	Dow Chemical Int'l Inc.	2,482	IBRD/IDA
Coral Gables	Exxon Caribbean Sales	5,337	IBRD/IDA
Coral Gables	Oflany Services Corp.	28	IDB
Coral Gables	Rohm & Haas Co.	101	IBRD/IDA
Coral Gables	R. R. General Textile	1,658	IBRD/IDA
Coral Gables	South American Hardwood Co.	968	IBRD/IDA
Coral Springs	Argo American Export Sales	992	IDB
Coral Springs	Argo American Export Sales	413	IDB
Coral Springs	Argo American Export Sales	331	IDB
Coral Springs	Argo American Export Sales	164	IDB

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Coral Springs	Argo American Export Sales	123	IDB
Coral Springs	Argo American Export Sales	72	IDB
Daytona	American Telephone & Telegraph Global	99	IDB
Deerfield Beach	Essex Exports	1,224	IDB
Deerfield Beach	Essex Exports	966	IDB
Deerfield Beach	Essex Exports	892	IDB
Deerfield Beach	Essex Exports	513	IDB
Deerfield Beach	Essex Exports	395	IDB
Deerfield Beach	Essex Exports	250	IDB
Deerfield Beach	Essex Exports	14	IDB
Deerfield Beach	Globaltronics Inc.	36	IDB
Deerfield Beach	M&W Pump Corp.	110	IIC
Fort Lauderdale	Ford New Holland	337	IDB
Fort Lauderdale	Ford New Holland	167	IDB
Fort Lauderdale	Ford New Holland	144	IDB
Fort Lauderdale	Horizon Development Corp.	366	IBRD/IDA
Fort Lauderdale	Massey Ferguson Exports	139	IDB
Fort Lauderdale	Massey Ferguson Exports	104	IDB
Fort Lauderdale	Motorola Inc.	1,025	IBRD/IDA
Fort Lauderdale	Motorola Inc.	570	IDB
Fort Lauderdale	Motorola Inc.	142	IDB
Fort Lauderdale	Nour Sirker	3	IDB

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Fort Lauderdale	Water Consultants Int'l	88	AFDB
Fort Meade	US Agri-Chemicals Corp.	1,948	IBRD/IDA
Gainesville	Donald Dickson	5	IDB
Gainesville	Maquinaria Y Tractores	71	IDB
Gainesville	Tropical & Research Development Inc.	333	IBRD/IDA
Gainesville	University of Florida	13	ADF
Hialeah	Grain Machinery Mfg. Corp.	39	IDB
Hialeah	Maple Int'l Inc.	137	IDB
Hialeah	Rem Int'l	49	IDB
Hollywood	Cisco	245	IDB
Hollywood	Interdisciplinary Project Consulting Inc.	306	IDB
Hollywood	Interdisciplinary Project Consulting Inc.	36	IDB
Hollywood	Interdisciplinary Project Consulting Inc.	35	IDB
Hollywood	Interdisciplinary Project Consulting Inc.	9	IDB
Hollywood	Walpeco	50	IDB
Jackson	John Deere Int'l	337	IBRD/IDA
Jacksonville	Besco Inc.	3,327	IBRD/IDA
Jacksonville	Besco Inc.	1,159	IBRD/IDA
Jacksonville	Besco Inc.	715	IBRD/IDA
Jacksonville	Besco Inc.	347	IBRD/IDA
Jacksonville	Camp Dresser & McKee Int'l	56	IBRD/IDA
Jacksonville	FWC Supply	94	IBRD/IDA

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Jacksonville	FWC Supply - Div. of Florida Wire & Cable	395	IBRD/IDA
Kissimmee	Maxon Engineering Service	237	IDB
Lake Alfred	Clayton MacCoy	4	IDB
Lakeland	Bromwell & Carrier Inc.	244	IBRD/IDA
Lakeland	Davy-McKee Corp.	807	IBRD/IDA
Lakeland	Davy-McKee Corp.	286	IBRD/IDA
Lakeland	Jacobs Int'l Ltd	3,776	IBRD/IDA
Lakeland	Jacobs Int'l Ltd	1,071	IBRD/IDA
Lakeland	Jacobs Int'l Ltd	357	IBRD/IDA
Longwood	Instruments Specialties Inc.	17	IIC
Medley	M/G Electric Manolo Garci	337	IDB
Melbourne	Harris Corp. - Farinon Division	2,442	IBRD/IDA
Miami	ABB Power T&D Co.	3,882	IDB
Miami	ABB Power T&D Co.	830	IDB
Miami	ABB Power T&D Co.	743	IBRD/IDA
Miami	ABB Power T&D Co.	534	IBRD/IDA
Miami	ABB Power T&D Co.	72	IDB
Miami	ABB Power T&D Co.	70	IDB
Miami	Alvimer Srl Trading Inc.	14	IDB
Miami	American Caribbean Corp.	194	IDB
Miami	American Caribbean Corp.	29	IDB
Miami	Americon Corp.	119	IBRD/IDA

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Miami	Antony Braham	157	IBRD/IDA
Miami	Arbrom Int'l Dist. Inc.	1,806	IBRD/IDA
Miami	Armstrong Export Inc.	144	IDB
Miami	Armstrong Export Inc.	60	IDB
Miami	Avianca	118	IBRD/IDA
Miami	A.P.C.	285	IBRD/IDA
Miami	Beeline Engineering & Construction	312	IBRD/IDA
Miami	Biomedical Int'l Corp.	785	IDB
Miami	Bode Export Corp.	195	IBRD/IDA
Miami	Calmaquip Engineering Corp.	418	IBRD/IDA
Miami	Caritrade Export Corp.	148	IBRD/IDA
Miami	Carmelo Mesa-Lago	7	IDB
Miami	Cartek Int'l Inc.	86	IDB
Miami	Cisco	1,296	IDB
Miami	Computation & Development, S.A.	501	IBRD/IDA
Miami	Comtech Supply Co.	173	IBRD/IDA
Miami	Condor Communications Inc.	275	IBRD/IDA
Miami	Cooper Power Systems Inc.	3,885	IDB
Miami	Cooper Power Systems Inc.	1,046	IBRD/IDA
Miami	Cooper Power Systems Inc.	748	IDB
Miami	Cooper Power Systems Inc.	652	IBRD/IDA
Miami	Cooper Power Systems Inc.	431	IBRD/IDA

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Miami	Cooper Power Systems Inc.	353	IDB
Miami	Cooper Power Systems Inc.	122	IDB
Miami	Cooper Power Systems Inc.	63	IBRD/IDA
Miami	Coriser of America	108	IBRD/IDA
Miami	Cosin Ltd	197	IBRD/IDA
Miami	Coulter Corp.	148	IDB
Miami	Cummings Americas Inc.	150	IBRD/IDA
Miami	Dewitt Tool Co.	68	IDB
Miami	Don Sherril & Associates	54	IDB
Miami	Dow Chemical Int'l Inc.	131	IBRD/IDA
Miami	Dow Chemical Int'l Inc.	131	IBRD/IDA
Miami	Dowtow Air Park	512	IBRD/IDA
Miami	DPI World Trade Inc.	386	IDB
Miami	Edge Group	647	IDB
Miami	Epson Latin America Inc.	432	IBRD/IDA
Miami	Epson Latin America Inc.	116	IBRD/IDA
Miami	Epson Latin America Inc.	4	IDB
Miami	Ernst & Young	622	IBRD/IDA
Miami	Essex Exports	452	IBRD/IDA
Miami	Exim Overseas Inc.	169	IBRD/IDA
Miami	Export Medical Technology	48	IDB
Miami	Ezcony Int'l	257	IBRD/IDA

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Miami	E.H.D. Co.	79	IDB
Miami	E.Y.G. Int'l Corp.	113	IBRD/IDA
Miami	Federico Poey	3	IDB
Miami	FELA Export Center	32	IDB
Miami	FERCA	1,694	IDB
Miami	Florida Chemical Ltd	1,070	IDB
Miami	Florida Chemical Ltd	603	IDB
Miami	Florida Chemical Ltd	440	IDB
Miami	Florida Chemical Ltd	221	IDB
Miami	Florida Chemical Ltd	201	IDB
Miami	Florida Chemical Ltd	200	IDB
Miami	Florida Chemical Ltd	200	IDB
Miami	Florida Chemical Ltd	193	IDB
Miami	Florida Chemical Ltd	188	IDB
Miami	Florida Chemical Ltd	182	IDB
Miami	Florida Chemical Ltd	176	IDB
Miami	Florida Chemical Ltd	148	IDB
Miami	Florida Chemical Ltd	142	IDB
Miami	Florida Chemical Ltd	124	IDB
Miami	Florida Chemical Ltd	115	IDB
Miami	Florida Chemical Ltd	105	IDB
Miami	Florida Chemicals & Trading Co.	1,163	IDB

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Miami	General Electric Co.	2,327	IDB
Miami	General Electric Co.	190	IBRD/IDA
Miami	General Exposervices Corp.	1,441	IDB
Miami	General Exposervices Corp.	873	IDB
Miami	General Exposervices Corp.	97	IDB
Miami	General Motors Overseas Distributors	9,453	IBRD/IDA
Miami	Global Products Int'l Inc.	24	IDB
Miami	Global Products Int'l Inc.	10	IDB
Miami	Global Trading Corp.	516	IDB
Miami	Harris Corp.	2,250	IBRD/IDA
Miami	Harris Corp.	1,173	IBRD/IDA
Miami	Harris Corp.	1,086	IBRD/IDA
Miami	Hastings & Hastings	12	IIC
Miami	Hazen & Sawyer	2,072	IDB
Miami	Hazen & Sawyer	2,008	IDB
Miami	Hazen & Sawyer	2,008	IDB
Miami	Hazen & Sawyer - Saybey Associates	2,105	IDB
Miami	Hazen & Sawyer - Saybey Associates	384	IBRD/IDA
Miami	Helm Fertilizer	543	IBRD/IDA
Miami	Hewlett Packard Co.	1,376	IBRD/IDA
Miami	Hewlett Packard Co.	137	IDB
Miami	Hide & Leather Supply Inc.	348	IBRD/IDA

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Miami	Hi-Tech Int'l	38	IDB
Miami	Hitech Solutions Inc.	150	IBRD/IDA
Miami	Industrial Instruments Export	476	IDB
Miami	Industrial Instruments Export	51	IDB
Miami	Ingersoll Rand Int'l	173	IDB
Miami	INTELEC Corp.	28	IDB
Miami	Inter-American Consulting Group	60	IDB
Miami	Inter-American Transport Equipment Co.	71	AFDB
Miami	Int'l Electrical Sales Corp.	3,013	IDB
Miami	Int'l High Tech Marketing Corp.	2	IBRD/IDA
Miami	Int'l High-Tech Marketing	141	IBRD/IDA
Miami	Intradeco Inc.	116	IBRD/IDA
Miami	Isrex Int'l	100	IBRD/IDA
Miami	I.C.S. Computer Bay	25	IDB
Miami	Jerry Bassin	997	IBRD/IDA
Miami	Joel Group Inc.	300	IDB
Miami	Junior Electronic Inc.	853	IBRD/IDA
Miami	J.C. Daly Inc.	21	IDB
Miami	J.C. Daly Inc.	7	IDB
Miami	Kasim Int'l Corp.	135	IDB
Miami	Kodak Export Ltd	173	IBRD/IDA
Miami	Komatsu Dresser Co.	493	IBRD/IDA

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Miami	Lab Enterprises Inc.	115	IBRD/IDA
Miami	Leica Inc.	15	IDB
Miami	L.A. Computer Exchange	36	IDB
Miami	L.A. Computer Exchange	23	IDB
Miami	Machinery Corp. of America	518	IBRD/IDA
Miami	Malone & Hyde Inc.	264	IBRD/IDA
Miami	Manhattan Shirts	242	IBRD/IDA
Miami	Martino Tire Co.	29	IDB
Miami	Mass Global Inc.	500	IBRD/IDA
Miami	Matra Inc.	741	IDB
Miami	Matra Inc.	418	IBRD/IDA
Miami	Matra Inc.	76	IDB
Miami	Medi-Tech Int'l	60	IDB
Miami	Metropolitan Plastics	137	IBRD/IDA
Miami	Miami Equipment & Exp. Co.	777	IDB
Miami	Micro Measurements Tech.	86	IDB
Miami	Micromix	220	IBRD/IDA
Miami	Moore Export Sales	230	IBRD/IDA
Miami	MTJ Int'l Trading Corp.	269	IBRD/IDA
Miami	M.B.A. Inc.	12	IIC
Miami	Newstech Co.	145	IBRD/IDA
Miami	Northern Telecom Co.	1,128	IBRD/IDA

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Miami	Northern Telecom Co.	915	IDB
Miami	Northern Telecom Co.	867	IBRD/IDA
Miami	Northern Telecom Co.	268	IBRD/IDA
Miami	Ohmeda Inc.	457	IBRD/IDA
Miami	Ohmeda Inc.	203	IDB
Miami	Olympus America Inc.	55	IDB
Miami	Omega Int'l	109	IBRD/IDA
Miami	Pacific Trading Overseas	108	IBRD/IDA
Miami	Paddington Paper & Supplies Inc.	764	IBRD/IDA
Miami	Paramount Trade Group	100	IDB
Miami	Penta Trade Inc.	198	IBRD/IDA
Miami	Perez Trading Co.	329	IBRD/IDA
Miami	Phelps Dodge Int'l Corp.	348	IBRD/IDA
Miami	Phoenix Trade Finance Corp.	132	IBRD/IDA
Miami	Pipe Steel of Florida Inc.	167	IBRD/IDA
Miami	Plastec U.S.A. Inc.	268	IBRD/IDA
Miami	Post, Buckley, Schuh & Jernigan	30	IDB
Miami	PPM-P&H Cranes Inc.	238	IDB
Miami	Precision Trading Corp.	113	IBRD/IDA
Miami	Quem Commercial Inc.	109	IBRD/IDA
Miami	Refricenter Int'l	63	IDB
Miami	Relma Int'l Inc.	54	IDB

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Miami	Rolm Corp.	109	IBRD/IDA
Miami	Roso Int'l Corp.	65	IDB
Miami	Scientific Supplies	270	IDB
Miami	Scientific Supplies	54	IDB
Miami	Seventy Three Corp.	2,990	IBRD/IDA
Miami	Smurfit Latin America	353	IBRD/IDA
Miami	Sony Broadcast Export Co.	203	IDB
Miami	Southeastern Paper Products	543	IBRD/IDA
Miami	Southern Atlantic Trading Co.	156	IBRD/IDA
Miami	Southwire Co.	578	IDB
Miami	S.K.F. Latintrade Inc.	111	IBRD/IDA
Miami	Tekni Communications	130	IDB
Miami	Tractor America Inc.	161	IBRD/IDA
Miami	Unilever Export B. V.	156	IBRD/IDA
Miami	Universal Trading & Engineering Corp.	8,000	IDB
Miami	Universal Trading & Engineering Corp.	2,513	IBRD/IDA
Miami	Universal Trading & Engineering Corp.	697	IDB
Miami	Universal Trading & Engineering Corp.	638	IDB
Miami	Universal Trading & Engineering Corp.	512	IDB
Miami	Universal Trading & Engineering Corp.	391	IDB
Miami	Universal Trading & Engineering Corp.	369	IDB
Miami	Universal Trading & Engineering Corp.	257	IDB

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Miami	Universal Trading & Engineering Corp.	238	IBRD/IDA
Miami	Universal Trading & Engineering Corp.	172	IDB
Miami	Universal Trading & Engineering Corp.	159	IBRD/IDA
Miami	Universal Trading & Engineering Corp.	155	IDB
Miami	Universal Trading & Engineering Corp.	122	IDB
Miami	Universal Trading & Engineering Corp.	119	IDB
Miami	Universal Trading & Engineering Corp.	115	IDB
Miami	Universal Trading & Engineering Corp.	107	IBRD/IDA
Miami	Universal Trading & Engineering Corp.	81	IDB
Miami	Universal Trading & Engineering Corp.	28	IDB
Miami	Westham Trade Corp.	201	IBRD/IDA
Miami	World Business Holding Corp.	109	IBRD/IDA
Miami	Yamaha Music Latin America	136	IBRD/IDA
Miami Beach	Int'l Marine Fishery	9	IIC
Miami Beach	Technical Resources Int'l	35	IDB
Miami Beach	Technical Resources Int'l	23	IBRD/IDA
Miami Lakes	Honeywell Inc.	2,679	IBRD/IDA
Miami Lakes	Honeywell Inc.	395	IBRD/IDA
Miramar	Macorix Trading Co.	13	IDB
Orlando	Chemical Taylor	112	IBRD/IDA
Orlando	Singer	225	IBRD/IDA
Palm Bay	Atmospheric Research Inc.	647	IDB

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Pombano Beach	Global Market Services	351	IBRD/IDA
Riverview	Cargill Fertilizer	6,365	ADB
Riverview	Cargill Fertilizer	5,928	ADB
San Remo	Garcia Colinas Trading	35	IDB
St. Petersburg	Geonex Int'l Inc.	3,345	IBRD/IDA
St. Petersburg	Geonex Int'l Inc.	2,014	IBRD/IDA
St. Petersburg	Geonex Int'l Inc.	1,199	ADB
Sunrise	Racal Datacom	22	IDB
Tallahassee	Florida State University	1,832	IBRD/IDA
Tallahassee	Florida State University	868	IBRD/IDA
Tampa	Aqua Systems Int'l Inc.	751	IDB
Tampa	Brown & Williams	125	IBRD/IDA
Tampa	BWIP Pump Int'l Inc.	53	IDB
Tampa	Dow Chemical Int'l Inc.	721	IBRD/IDA
Tampa	Greeley & Hansen	2,072	IDB
Tampa	Grinnell Co.	64	IDB
Tampa	Hazen & Sawyer	2,072	IDB
Tampa	Navistar Co.	627	IDB
Tampa	U.S. Chemical Resources Inc.	15,105	IBRD/IDA
Tampa	U.S. Chemical Resources Inc.	4,433	IBRD/IDA
Tampa	U.S. Chemical Resources Inc.	1,688	IBRD/IDA
Unspecified	Air Shields Vickers Medical	1,057	IBRD/IDA

FLORIDA

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	A.H. Nance	34	IBRD/IDA
Unspecified	Bioserv Inc.	122	IBRD/IDA
Unspecified	Dantzler Lumber & Export	170	IBRD/IDA
Unspecified	Earth Satellite	59	IBRD/IDA
Unspecified	Excelsior Trading Co.	175	IBRD/IDA
Unspecified	Gulf Supply Exports Inc.	225	IBRD/IDA
Unspecified	H. Snyder	30	IBRD/IDA
Unspecified	Inter-American Transport Co.	264	IBRD/IDA
Unspecified	J. Warren	7	IBRD/IDA
Unspecified	Latin Import & Export Inc.	1,242	IBRD/IDA
Unspecified	Louis Austin	122	IBRD/IDA
Unspecified	L.S. Group Corp.	112	IBRD/IDA
Unspecified	Maya Enterprises Inc.	198	IBRD/IDA
Unspecified	Medrep - Biomed Ltd	276	IBRD/IDA
Unspecified	Neal & Massey	121	IBRD/IDA
Unspecified	Rossi Int'l	211	IBRD/IDA
Unspecified	Sargent Int'l - Ford	1,400	IBRD/IDA
Unspecified	Technical Int'l Corp.	613	IBRD/IDA
Unspecified	Thomas G. Steigerwald	16	IBRD/IDA
Unspecified	Undetermined	17,040	IBRD/IDA
Winter Park	C.E.S.	19	IDB
State Total		229,406	

GEORGIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Alpharetta	Siemens Energy & Automation Inc.	2,652	IBRD/IDA
Alpharetta	Siemens Energy & Automation Inc.	63	IBRD/IDA
Alpharetta	Siemens Energy & Automation Inc.	43	IDB
Alpharetta	Siemens Energy & Automation Inc.	7	ADB
Atlanta	A.T. Kearney Inc.	595	IDB
Atlanta	Bristol Laboratories Int'l S.A.	1,017	IBRD/IDA
Atlanta	Bristol Myers Squibb Co.	189	IBRD/IDA
Atlanta	Buffalo Color Corp.	396	IBRD/IDA
Atlanta	Carter Center at Emory University	90	IDB
Atlanta	Coats & Clark Inc.	164	IBRD/IDA
Atlanta	Coca Cola Corp.	52,800	EBRD
Atlanta	Coca Cola Corp.	2,900	EBRD
Atlanta	Coca Cola Corp.	108	IBRD/IDA
Atlanta	Coca Cola Trading	783	IBRD/IDA
Atlanta	Ebbarc Int'l	6	IIC
Atlanta	Gate City Oil Equipment Co.	111	IBRD/IDA
Atlanta	Harris Corp.	143	IBRD/IDA
Atlanta	Langdale Int'l Trading Corp.	4,322	IBRD/IDA
Atlanta	Langdale Int'l Trading Corp.	1,157	IBRD/IDA
Atlanta	Langdale Int'l Trading Corp.	1,087	IBRD/IDA
Atlanta	Langdale Int'l Trading Corp.	762	IBRD/IDA
Atlanta	Langdale Int'l Trading Corp.	144	IBRD/IDA

GEORGIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Atlanta	Monsanto Co.	268	IBRD/IDA
Atlanta	Monsanto Int'l Sales Co.	1,749	IBRD/IDA
Atlanta	National Pump Co.	13	IIC
Atlanta	On Line Financial Communications Systems	125	IBRD/IDA
Atlanta	Reliance Communications Technology	2,970	IBRD/IDA
Atlanta	Southern Electric Int'l Inc.	2,190	IBRD/IDA
Atlanta	Southern Electric Int'l Inc.	1,783	IBRD/IDA
Atlanta	Southern Electric Int'l Inc.	219	IBRD/IDA
Atlanta	Southern Electric Int'l Inc.	145	IBRD/IDA
Atlanta	Walton-Stout Inc.	115	IBRD/IDA
Atlanta	Wilson Tire & Supply Co.	125	IBRD/IDA
Baldwin	Southern Seed Co.	291	IBRD/IDA
Carrolton	Southwire Co.	1,487	IBRD/IDA
College Park	Utility Supply & Equipment Corp.	248	IBRD/IDA
Columbia	Lummus Industries Inc.	1,386	IBRD/IDA
Columbia	Lummus Industries Inc.	608	IBRD/IDA
Columbus	Lummus Industries Inc.	2,121	IBRD/IDA
Gainesville	Cantrell Machines	21	IIC
Garland	Merla	155	IBRD/IDA
Newnam	Johnson Yokogawa Corp.	1,928	IIC
Newnam	Johnson Yokogawa Corp.	30	IIC
Norcross	Micromeritics Instrument	65	IDB

GEORGIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Norcross	Mita Copystar America Inc.	14	IDB
Norcross	Schlumberger Industries Inc.	8,673	IBRD/IDA
Norcross	Schlumberger Industries Inc.	1,398	ADB
Norcross	Schlumberger Industries Inc.	698	IDB
Norcross	Schlumberger Industries Inc.	358	IDB
Norcross	Schlumberger Industries Inc.	253	IBRD/IDA
Norcross	Schlumberger Industries Inc.	213	IBRD/IDA
Norcross	Schlumberger Industries Inc.	190	IBRD/IDA
Norcross	Scientific Atlanta Inc.	2,100	EBRD
Norcross	Scientific Atlanta Inc.	101	IBRD/IDA
Norcross	Sony Recording Medical	4	IDB
Savannah	Carver Inc.	1,396	ADB
Savannah	M1 Overseas	110	IBRD/IDA
Savannah	New Sulzer Diesel	422	IDB
South Carrolton	West Georgia Farm Power	113	IBRD/IDA
Stone Mountain	Ashford Int'l Inc.	961	IBRD/IDA
Stone Mountain	Ashford Int'l Inc.	740	IBRD/IDA
Stone Mountain	Ashford Int'l Inc.	572	IBRD/IDA
Unspecified	James G. Else	155	IBRD/IDA
Unspecified	Phillips Lighting Co.	284	IBRD/IDA
Unspecified	Undetermined	1,394	IBRD/IDA
Warner Robins	Tom G. Beckman	3	IDB

GEORGIA

CITY	COMPANY	AMOUNT ($'000)	BANK
West Point	West Point Foundry & Machine Co.	230	IBRD/IDA
State Total		107,963	

HAWAII

CITY	COMPANY	AMOUNT ($'000)	BANK
Honolulu	East-West Center	499	ADB
Honolulu	Edward Scura & Associates	8	IIC
Honolulu	Jane Kinoshita	112	ADF
Honolulu	Nature Conservancy	576	ADB
Honolulu	Undetermined	441	ADB
Honolulu	Upham Int'l	886	IBRD/IDA
Honolulu	Upham Int'l	469	IBRD/IDA
Honolulu	Upham Int'l	378	IBRD/IDA
Honolulu	Upham Int'l	315	IBRD/IDA
Honolulu	Upham Int'l	162	IBRD/IDA
Honolulu	Upham Int'l	162	IBRD/IDA
Unspecified	Micro Age Computer	11	ADF
Unspecified	Undetermined	102	IBRD/IDA
State Total		4,121	

IDAHO

CITY	COMPANY	AMOUNT ($'000)	BANK
Boise	Aresco Inc.	300	IBRD/IDA
Boise	Morrison-Knudsen Engineering Corp.	400	IBRD/IDA
Moscow	University of Idaho	18	ADF
Unspecified	Undetermined	25	IBRD/IDA
State Total		743	

ILLINOIS

CITY	COMPANY	AMOUNT ($'000)	BANK
Bannockburn	C.W. Costello & Assoc.	15	EBRD
Beloit	Litton Industrial Automation	253	IBRD/IDA
Blue Island	G & W Electric Co. Ltd	219	IBRD/IDA
Broadview	Navistar Int'l Transportation Corp.	409	IBRD/IDA
Broadview	Navistar Int'l Transportation Corp.	1,186	IBRD/IDA
Broadview	Navistar Int'l Transportation Corp.	994	IDB
Broadview	Navistar Int'l Transportation Corp.	1,225	IDB
Broadview	Navistar Int'l Transportation Corp.	494	ADF
Broadview	Navistar Int'l Transportation Corp.	374	IDB
Broadview	Navistar Int'l Transportation Corp.	240	IDB
Chicago	Abbot Lab Int'l Co.	324	IBRD/IDA
Chicago	Abbot Lab. Diag. Division	160	IDB
Chicago	ABC Rail Corp.	8,252	IBRD/IDA
Chicago	Ameritech	60,000	EBRD
Chicago	Amoco Chemicals Co.	1,243	IBRD/IDA
Chicago	Andrew Corp.	4,000	EBRD
Chicago	Arthur Anderson & Co.	1,292	IBRD/IDA
Chicago	Arthur Anderson & Co.	500	IBRD/IDA
Chicago	A.T. Kearney Inc.	352	IBRD/IDA
Chicago	C & F Electric Co.	1,373	IBRD/IDA
Chicago	Chicago Citrus Int'l Inc.	16	IBRD/IDA
Chicago	Continental Grain Co.	3,794	AFDB

ILLINOIS

CITY	COMPANY	AMOUNT ($'000)	BANK
Chicago	Cooper Industries	260	IBRD/IDA
Chicago	Energy Services Group	114	IBRD/IDA
Chicago	General Motors Corp.	3,593	IBRD/IDA
Chicago	General Motors Corp.	2,302	IBRD/IDA
Chicago	General Motors Corp.	1,978	IBRD/IDA
Chicago	Golub & Co.	9,000	EBRD
Chicago	Hansen-Holm-Alanso Co. - Coopers Lybrand	1,050	IDB
Chicago	Harza Engineering Co.	4,249	IBRD/IDA
Chicago	Harza Engineering Co.	960	IBRD/IDA
Chicago	Harza Engineering Co.	778	IDB
Chicago	Harza Engineering Co.	747	IBRD/IDA
Chicago	Harza Engineering Co.	602	IBRD/IDA
Chicago	Harza Engineering Co.	422	IDB
Chicago	Harza Engineering Co.	220	IBRD/IDA
Chicago	Harza Engineering Co.	130	IBRD/IDA
Chicago	Heller Int'l Group	600	IFC
Chicago	Hyatt Int'l	19,460	EBRD
Chicago	IIT Research Institute	1,160	IBRD/IDA
Chicago	Institute of Gas Technology	925	IBRD/IDA
Chicago	John Deere & Co.	1,350	IBRD/IDA
Chicago	KPMG Peat Marwick	301	IBRD/IDA
Chicago	Midwest Electric Co.	72	IDB

ILLINOIS

CITY	COMPANY	AMOUNT ($'000)	BANK
Chicago	Millennium Computing Group	40	EBRD
Chicago	Motorola Int'l Development Corp.	17,000	MIGA
Chicago	Phosphate Chemical Export Assoc.	20,821	ADB
Chicago	Phosphate Chemical Export Assoc.	1,209	IBRD/IDA
Chicago	Phosphate Chemical Export Assoc.	192	IBRD/IDA
Chicago	Power Parts	728	IBRD/IDA
Chicago	Precision Scientific Inc.	50	IDB
Chicago	Precision Scientific Inc.	6	IDB
Chicago	Rhone-Poulenc Film Co.	128	IBRD/IDA
Chicago	Sargent & Lundy	521	IBRD/IDA
Chicago	Schwinn Bicycle Co.	954	IFC
Chicago	Shorebank Corp.	914	EBRD
Chicago	Shorebank Corp.	621	EBRD
Chicago	Signal Int'l Inc.	711	IBRD/IDA
Chicago	Signal Int'l Inc.	111	IBRD/IDA
Chicago	South Shore Bank of Chicago	17	EBRD
Chicago	S&C Electric Company	29	IDB
Chicago	TDK Corp. of America	357	IBRD/IDA
Danville	Hyster Co.	2,063	IBRD/IDA
Danville	Hyster Co.	59	IDB
Decatur	Archer Daniels Midland Co.	3,585	AFDB
Decatur	Archer Daniels Midland Co.	884	IBRD/IDA

ILLINOIS

CITY	COMPANY	AMOUNT ($'000)	BANK
Decatur	Ilinova Generating Co.	14,000	MIGA
Decatur	Mueller Co.	83	IDB
Decatur	Mueller Co.	75	ADF
Deerfield	Baxter Int'l Inc.	3,000	EBRD
Deerfield	United Conveyor Corp.	3,642	IBRD/IDA
Deerfield	United Conveyor Corp.	1,081	IBRD/IDA
Des Plaines	VOP Inter Americana Inc.	1,502	IBRD/IDA
Des Plaines	VOP Inter Americana Inc.	420	IBRD/IDA
Des Plaines	VOP Inter Americana Inc.	285	IBRD/IDA
Des Plaines	VOP Inter Americana Inc.	148	IBRD/IDA
Detroit	Rockwell Graphics Inc.	323	IBRD/IDA
Downers Grove	Engineering Equipment Co.	1,155	IBRD/IDA
Downers Grove	Engineering Equipment Co.	283	IBRD/IDA
Downers Grove	Engineering Equipment Co.	53	IBRD/IDA
Franklin Park	Castle Group	18,806	IFC
Glencoe	Global Finance Corp.	22	IIC
Glencoe	Global Finance Corp.	1	IIC
Godfrey	Owens Illinois Inc.	1,724	IBRD/IDA
Godfrey	Owens Illinois Inc.	1,450	IBRD/IDA
Hazelcrest	MI-Jack Products	3,036	IBRD/IDA
Hazelcrest	MI-Jack Products	1,658	IBRD/IDA
Hazelcrest	MI-Jack Products	1,220	IBRD/IDA

ILLINOIS

CITY	COMPANY	AMOUNT ($'000)	BANK
Highland Park	Fusion Enterprises	4,000	EBRD
Lake Bluff	Soiltest Inc.	45	IDB
Long Grove	Kemper Corp.	2,391	IFC
Long Grove	Kemper Corp.	159	IFC
Melrose Park	Lab Line Inst. Int'l Corp.	35	IDB
Milwaukee	Anchor Hocking Packaging Co.	52	IIC
Moline	John Deere Intercontinental Ltd	2,407	IBRD/IDA
Moline	John Deere Intercontinental Ltd	1,045	IBRD/IDA
Moline	John Deere Intercontinental Ltd	908	IBRD/IDA
Moline	John Deere Intercontinental Ltd	441	IBRD/IDA
Niles	Cole-Parmer Int'l	26	IDB
Olenview	Zenith Electronics Corp.	142	IBRD/IDA
Oregon	E.D. Etnyre & Co.	289	IBRD/IDA
Orlando Park	Andrew Corp.	4,000	EBRD
Peoria	Caterpillar Inc.	11,368	IBRD/IDA
Peoria	Caterpillar Inc.	8,452	IBRD/IDA
Peoria	Caterpillar Inc.	3,649	IBRD/IDA
Peoria	Caterpillar Inc.	1,550	IBRD/IDA
Peoria	Caterpillar Inc.	104	AFDB
Peoria	Caterpillar Inc.	71	IDB
Peoria	Dresser Marketing Division	345	IBRD/IDA
Peoria	Komatsu Dresser Co.	1,563	IBRD/IDA

ILLINOIS

CITY	COMPANY	AMOUNT ($'000)	BANK
Peoria	Komatsu Dresser Co. - Haulpak Division	54	AFDB
Rock Island	Serbus Footwear Company	21	IDB
Rosemont	Phosphate Chemical Export Assoc.	5,256	ADF
Schaumburg	Motorola Inc.	995	IBRD/IDA
Skokie	U.S. Robotics	1	IDB
Streator	Peabody Myers	1,139	IDB
Taylorville	GE Mor Inc.	191	IBRD/IDA
Unspecified	Alfred J. Hendron, Jr.	30	IBRD/IDA
Unspecified	Alfred J. Hendron, Jr.	26	IBRD/IDA
Unspecified	American Int'l Radio	1,227	IBRD/IDA
Unspecified	Electro Motive Division	5,422	IBRD/IDA
Unspecified	Epstein Engineering Export Ltd	2,220	IBRD/IDA
Unspecified	Epstein Engineering Export Ltd	1,295	IBRD/IDA
Unspecified	Harris Corp.	53	IBRD/IDA
Unspecified	Robert A. Lyon	147	IBRD/IDA
Unspecified	Undetermined	15,631	IBRD/IDA
Unspecified	Undetermined	14,165	ADB
Unspecified	Velsicol Chemical	127	IBRD/IDA
Waukegan	United Conveyor Corp.	3,230	IBRD/IDA
West Lafayette	Bernard Engel	25	IDB
Woodstock	Automatic Liquid Packaging Inc.	274	IBRD/IDA
State Total		336,526	

INDIANA

CITY	COMPANY	AMOUNT ($'000)	BANK
Bloomington	ABB Power T&D Inc.	116	IDB
Bloomington	Indiana University	68	ADB
Columbus	Cummins Engine Co.	617	IBRD/IDA
Columbus	Cummins Engine Co.	28	IBRD/IDA
Evansville	Robur Corp.	130	ADB
Hammond	Specialty Steel Products Inc.	125	IBRD/IDA
Indianapolis	Angus Electronics	25	IDB
Indianapolis	Eli Lilly Interamerica Inc.	340	IBRD/IDA
Indianapolis	P. S. Int'l Ltd	171	IBRD/IDA
Indianapolis	Wood Mizer Products Inc.	40	IDB
Jeffersonville	Amatrol Inc.	632	IBRD/IDA
Lafayette	Landis & Gyr	2,130	IDB
Milford	Chore-Time - Brock Int'l	89	IDB
Neurg	Aluminum Co. of America	133	IBRD/IDA
Unspecified	Undetermined	849	IBRD/IDA
State Total		5,493	

IOWA

CITY	COMPANY	AMOUNT ($'000)	BANK
Cedar Rapids	Undetermined	11,204	ADB
Cedar Rapids	Universal Engineering Corp.	116	IBRD/IDA
Des Moines	Little Giant Crane & Shovel	1,334	IBRD/IDA
Johnson	Pioneer Bred Int'l	185	IBRD/IDA
Johnson	Pioneer Bred Int'l	158	IBRD/IDA
Muscatine	Stanley Consultants Inc.	277	AFDB
Unspecified	Iowa Mold Tooling	2,766	IDB
Unspecified	Undetermined	221	IBRD/IDA
State Total		16,261	

KANSAS

CITY	COMPANY	AMOUNT ($'000)	BANK
El Dorado	Cardwell Int'l Ltd	3,249	IBRD/IDA
El Dorado	Cardwell Int'l Ltd	984	IBRD/IDA
El Dorado	Cardwell Int'l Ltd	357	IBRD/IDA
El Dorado	Cardwell Int'l Ltd	220	IBRD/IDA
Kansas City	Darlett and Co.	4,166	IBRD/IDA
Kansas City	Global Graphics Inc.	113	IBRD/IDA
Kansas City	Marba Enterprises Inc.	121	IBRD/IDA
Lenexa	PPG Industries Inc.	69	IDB
Manhattan	Kansas State University	179	IBRD/IDA
Manhattan	Kansas State University	73	IBRD/IDA
Neodesha	M.E. Co.	1,173	IBRD/IDA
Overland Park	Pritchard	624	IBRD/IDA
Overland Park	Pritchard	111	IBRD/IDA
Shawnee	Express Scale Parts Inc.	241	IBRD/IDA
Unspecified	Undetermined	24	IBRD/IDA
Westwood	Sprint - Salomon Brothers	25,000	IFC
Wichita	Thermadyne Industries	85	IDB
State Total		36,789	

KENTUCKY

CITY	COMPANY	AMOUNT ($'000)	BANK
Lexington	Clark Material Handling	96	IBRD/IDA
Lexington	Clark Material Handling	89	AFDB
Louisville	Cissell	7	IDB
Louisville	General Electric Co.	354	IBRD/IDA
Louisville	Undetermined	24	ADB
Louisville	Utility Metals	110	IDB
Louisville	Utility Metals	227	IDB
Unspecified	Undetermined	610	IBRD/IDA
State Total		1,517	

LOUISIANA

CITY	COMPANY	AMOUNT ($'000)	BANK
	LOUISIANA		
Alexandria	Dis-Tran Products Inc.	17	IDB
Atlanta	Int'l Paper Co.	1,045	IBRD/IDA
Baton Rouge	Ethyl Corp.	628	IBRD/IDA
Baton Rouge	F.C. Schaffer Associates Inc.	374	AFDB
Baton Rouge	F.C. Schaffer Associates Inc.	148	IBRD/IDA
Baton Rouge	Technology Training Inc.	67	AFDB
Drestrehan	Bunge Corp.	2,273	IBRD/IDA
Kenner	Pellerin Milnor Co.	169	IDB
Lafayette	Completion Accessories Inc.	148	IBRD/IDA
Lake Charles	Eastlake Oils Inc.	144	IDB
Lake Charles	Impeinsa	547	IBRD/IDA
New Orleans	Dole Fresh Fruit Co.	178	IBRD/IDA
New Orleans	D.L. Harrison	9,383	IDB
New Orleans	McDermott	78,728	IBRD/IDA
Pauline	Multifoods	1,845	IBRD/IDA
Thibodaux	Cameco Industries Inc.	2,255	IBRD/IDA
Thibodaux	Cameco Industries Inc.	1,950	IBRD/IDA
Thibodaux	Cameco Industries Inc.	779	IBRD/IDA
Thibodaux	Cameco Industries Inc.	553	AFDB
Thibodaux	Cameco Industries Inc.	324	IBRD/IDA
Thibodaux	Cameco Industries Inc.	156	IBRD/IDA

LOUISIANA

CITY	COMPANY	AMOUNT ($'000)	BANK
Thibodaux	Quality Industries Inc.	206	IBRD/IDA
Unspecified	Mohamed Ben Senia	4	IBRD/IDA
Unspecified	Undetermined	781	IBRD/IDA
State Total		102,702	

MARYLAND

CITY	COMPANY	AMOUNT ($'000)	BANK
Accident	Phenix	23	IDB
Annapolis	Wartsila Diesel Development Corp.	27,000	MIGA
Annapolis	Wartsila Diesel Development Corp.	14,192	IFC
Annapolis	Wartsila Diesel Development Corp.	2,000	MIGA
Baltimore	A.J. Sachett & Sons	345	IBRD/IDA
Baltimore	Catholic Relief Services	20	IDB
Baltimore	Johns Hopkins University	25	IBRD/IDA
Baltimore	Katalystics Inc.	139	IBRD/IDA
Baltimore	OMG Book Source Co.	136	IBRD/IDA
Baltimore	OMG Book Source Co.	21	IBRD/IDA
Baltimore	Paul Marsh	187	IBRD/IDA
Baltimore	Science Instruments Co.	592	IBRD/IDA
Baltimore	Science Instruments Co.	230	IBRD/IDA
Baltimore	STV Lyon Associates Inc.	10,188	IBRD/IDA
Baltimore	STV Lyon Associates Inc.	5,290	IBRD/IDA
Baltimore	STV Lyon Assoc. Inc.	1,563	IBRD/IDA
Baltimore	Vesuvius Corp. S. A.	210	IBRD/IDA
Baltimore	W.R. Grace & Co.	505	IBRD/IDA
Baltimore	W.R. Grace & Co.	6	ADF
Bethesda	Booz, Allen & Hamilton Inc.	696	EBRD
Bethesda	Carol Lewis	49	IDB
Bethesda	Construction Administration Services	12	IDB

MARYLAND

CITY	COMPANY	AMOUNT ($'000)	BANK
Bethesda	Development Alternatives Inc.	1,703	IBRD/IDA
Bethesda	Development Alternatives Inc.	1,584	IBRD/IDA
Bethesda	Development Alternatives Inc.	246	IBRD/IDA
Bethesda	Development Alternatives Inc.	197	IDB
Bethesda	Development Alternatives Inc.	180	ADB
Bethesda	Development Alternatives Inc.	161	IBRD/IDA
Bethesda	Development Alternatives Inc.	60	IDB
Bethesda	Development Alternatives Inc.	39	IDB
Bethesda	Development Alternatives Inc.	30	IDB
Bethesda	Development Alternatives Inc.	25	IDB
Bethesda	Development Alternatives Inc.	19	IDB
Bethesda	Development Alternatives Inc.	8	IDB
Bethesda	Esquel Group Foundation	15	IDB
Bethesda	Marriott Int'l Inc.	4,300	MIGA
Bethesda	University Research Corp.	202	IBRD/IDA
Bethesda	University Research Corp.	135	IBRD/IDA
Bethesda	University Research Corp.	25	IDB
Buckeystown	Roy Jorgensen Associates Inc.	599	IDB
Columbia	Institute for Resource Development	916	IBRD/IDA
Columbia	Institute for Resource Development	112	IBRD/IDA
Derwood	Latinvironment	34	IDB
Gaithersburg	De Leuw Cather Int'l	1,665	IBRD/IDA

MARYLAND

CITY	COMPANY	AMOUNT ($'000)	BANK
Gaithersburg	De Leuw Cather Int'l	1,582	IBRD/IDA
Gaithersburg	De Leuw Cather Int'l	666	IBRD/IDA
Gaithersburg	Roy Jorgensen Associates Inc.	1,584	IBRD/IDA
Gaithersburg	Roy Jorgensen Associates Inc.	67	IBRD/IDA
Gulfport	Dole Fresh Fruit Co.	379	IBRD/IDA
Jefferson	Int'l Project Services Inc.	6	IDB
Jefferson	Int'l Project Services Inc.	6	IDB
Newburg	Stimson Eveleth	12	EBRD
Rockville	Engineering, Management & Economics	164	IDB
Rockville	Engineering, Management & Economics	8	IDB
Rockville	Pulse Electronics Inc.	556	IBRD/IDA
Rockville	Sheladia Associates Inc.	1,787	IBRD/IDA
Rockville	Sheladia Associates Inc.	224	IBRD/IDA
Rockville	Sheladia Associates Inc.	207	IBRD/IDA
Rockville	Sheladia Associates Inc.	35	IBRD/IDA
Rockville	Sheladia Associates Inc.	1	IDB
Rockville	TAMS - Sheladia - Davies Associates	720	IBRD/IDA
Silver Spring	Alternative Energy Development Inc.	170	IDB
Silver Spring	Alternative Energy Development Inc.	16	IDB
Silver Spring	Comsis Corp.	271	IBRD/IDA
Silver Spring	Comsis Corp.	199	IBRD/IDA
Silver Spring	Comsis Corp.	157	IBRD/IDA

MARYLAND

CITY	COMPANY	AMOUNT ($'000)	BANK
Silver Spring	Cooperative Housing Foundation	88	IBRD/IDA
Silver Spring	Fred Pshyk	160	IBRD/IDA
Silver Spring	NIR System	60	IDB
Unspecified	Douglas L. Adkins	18	IBRD/IDA
Unspecified	Intrade Intercontinental Inc.	385	IBRD/IDA
Unspecified	Intrade Intercontinental Inc.	128	IBRD/IDA
Unspecified	Intrade Intercontinental Inc.	106	IBRD/IDA
Unspecified	John Mobarak	10	IBRD/IDA
Unspecified	Melville S. Brown	84	IBRD/IDA
Unspecified	Moffatt - Inecon	69	IBRD/IDA
Unspecified	Rayco	60	IBRD/IDA
Unspecified	Undetermined	2,118	IBRD/IDA
Unspecified	William Brooner	58	IBRD/IDA
State Total		87,845	

MASSACHUSETTS

CITY	COMPANY	AMOUNT ($'000)	BANK
Andover	Modicon Inc.	104	IBRD/IDA
Bedford	Baird Corp.	192	IBRD/IDA
Bedford	Baird Corp.	124	ADB
Boston	Advent Int'l Corp.	17,500	EBRD
Boston	Advent Int'l Corp.	10,000	IFC
Boston	Advent Int'l Corp.	10,000	IFC
Boston	Advent Int'l Corp.	2,500	EBRD
Boston	AEMC Instruments	17	IDB
Boston	AGFA Comp. Division	1,107	IBRD/IDA
Boston	Boston Safe Deposit & Trust Co.	10,000	IFC
Boston	Boston University	229	IBRD/IDA
Boston	Boston University	192	IBRD/IDA
Boston	Boston University	103	IBRD/IDA
Boston	Camp Dresser & McKee Inc.	469	IBRD/IDA
Boston	Camp Dresser & McKee Inc.	58	IBRD/IDA
Boston	Center for Int'l Health	165	AFDB
Boston	Charles River Associates Inc.	30	IDB
Boston	Charles River Associates Inc.	30	IDB
Boston	Clafin Capital Management	3,500	EBRD
Boston	First Boston - Merrill Lynch	133	IBRD/IDA
Boston	General Electric Co.	160	IBRD/IDA
Boston	Int'l Forest Prod. Corp.	907	IBRD/IDA

MASSACHUSETTS

CITY	COMPANY	AMOUNT ($'000)	BANK
Boston	John Snow Inc.	212	IDB
Boston	Management Science for Health	148	IBRD/IDA
Boston	Management Science for Health	70	IDB
Boston	Northeastern University	560	IBRD/IDA
Boston	Northeastern University	335	IBRD/IDA
Boston	Pioneer Group	7,500	EBRD
Boston	Scudder Latin American Trust	6,000	MIGA
Boston	Seymour Paper	8	IDB
Boston	Stone & Webster Eng. Ltd	999	IBRD/IDA
Boston	Stone & Webster Eng. Ltd	624	IBRD/IDA
Boston	Stone & Webster Eng. Ltd	165	IBRD/IDA
Boston	Stone & Webster Eng. Ltd	155	IBRD/IDA
Boston	Tellus Institute for Res. & Env. Strategies	28	IDB
Boston	Wang Laboratories Inc.	275	IBRD/IDA
Boston	White Eagle Industries - Schooner Capital Corp.	29,700	EBRD
Boston	World Education Inc.	1,480	ADB
Braintree	Fisher-Pierce	108	IDB
Braintree	Fisher-Pierce	59	IDB
Cambridge	ABT Associates Inc.	100	IBRD/IDA
Cambridge	ABT Associates Inc.	30	IBRD/IDA
Cambridge	ABT Associates Inc.	30	IDB
Cambridge	ABT Associates Inc.	20	IDB

MASSACHUSETTS

CITY	COMPANY	AMOUNT ($'000)	BANK
Cambridge	Arthur D. Little Int'l	4,908	IBRD/IDA
Cambridge	Arthur D. Little Int'l	1,574	IBRD/IDA
Cambridge	Arthur D. Little Int'l	1,448	IBRD/IDA
Cambridge	Arthur D. Little Int'l	1,225	IBRD/IDA
Cambridge	Arthur D. Little Int'l	759	IBRD/IDA
Cambridge	Arthur D. Little Int'l	557	IBRD/IDA
Cambridge	Arthur D. Little Int'l	178	IBRD/IDA
Cambridge	Bio-Rad - Digilab Division	243	IBRD/IDA
Cambridge	Camp Dresser & McKee Inc.	3,853	IBRD/IDA
Cambridge	Camp Dresser & McKee Inc.	121	IBRD/IDA
Cambridge	De Lucia Assoc. Inc.	443	IBRD/IDA
Cambridge	De Lucia Assoc. Inc.	230	IBRD/IDA
Cambridge	De Lucia Assoc. Inc.	134	IBRD/IDA
Cambridge	De Lucia Assoc. Inc.	35	IBRD/IDA
Cambridge	E.L.I. Inc.	57	AFDB
Cambridge	Harvard Institute for Int'l Development	2,477	IBRD/IDA
Cambridge	Harvard Institute for Int'l Development	1,979	IBRD/IDA
Cambridge	Harvard Institute for Int'l Development	283	AFDB
Cambridge	Harvard Institute for Int'l Development	257	IBRD/IDA
Cambridge	Harvard Institute for Int'l Development	100	IDB
Cambridge	Harvard Institute for Int'l Development	50	EBRD
Cambridge	Harvard Institute for Int'l Development	49	IBRD/IDA

MASSACHUSETTS

CITY	COMPANY	AMOUNT ($'000)	BANK
Cambridge	Harvard Law School	232	IBRD/IDA
Cambridge	Harvard School of Public Health	1,200	IDB
Cambridge	Harvard School of Public Health	100	IDB
Cambridge	Harvard University	1,133	IBRD/IDA
Cambridge	Harvard University	468	IBRD/IDA
Cambridge	Harvard University	432	IBRD/IDA
Cambridge	Harvard University	353	IBRD/IDA
Cambridge	Idikon Co.	133	IBRD/IDA
Cambridge	Int'l Technical Action	50	IDB
Cambridge	Int'l Technical Action	16	IDB
Cambridge	Int'l Technical Action	15	IDB
Cambridge	Int'l Technical Action	15	IDB
Cambridge	Michel Resnick	1	IDB
Danvers	GTE Products Corp.	105	IBRD/IDA
Danvers	Senechal, Jorgenson, Hale & Co.	36	EBRD
East Longmeadow	Hampton Engineering	71	IDB
Foxboro	Foxboro Co.	444	IBRD/IDA
Franklin	Thermo Jarrell Ash	135	EBRD
Lexington	Mercer Management Consulting Inc.	138	IBRD/IDA
Lexington	Mercer Management Consulting Inc.	3	EBRD
Lexington	Sherbrooke Associates	102	EBRD
Mansfield	Motorola Information Systems Group	248	IBRD/IDA

MASSACHUSETTS

CITY	COMPANY	AMOUNT ($'000)	BANK
Maynard	Digital Equipment Corp.	273	IDB
Maynard	Digital Equipment Corp.	3	IBRD/IDA
Milton	Bankers Collaborative	355	IDB
Milton	Bankers Collaborative	7	IDB
Needham Heights	IEC Int'l Equipment	46	IDB
Needham Heights	IEC Int'l Equipment	7	IDB
Newton	Education Development Center	1,106	IBRD/IDA
Newton	Education Development Center	910	IBRD/IDA
Newton	Education Development Center	285	IBRD/IDA
Newton	Education Development Center	164	IBRD/IDA
Northboro	Digital Equipment Corp.	2,081	IBRD/IDA
Northboro	Digital Equipment Corp.	714	IBRD/IDA
Northboro	Digital Equipment Corp.	431	IBRD/IDA
Northboro	Digital Equipment Corp.	431	IBRD/IDA
Norwell	Mentor Corp.	15	IDB
Peabody	Boaleeco	148	IBRD/IDA
Peabody	Boaleeco	104	IBRD/IDA
Peabody	Jeol USA Inc.	321	IBRD/IDA
Peabody	Jeol USA Inc.	157	IBRD/IDA
Randolph	Codman & Shurtleff Inc.	263	IDB
Tewksbury	Wang Laboratories Inc.	159	IDB
Unspecified	Badger Engineering Inc.	606	IBRD/IDA

MASSACHUSETTS

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Blue Nile Associates	16	IBRD/IDA
Unspecified	Bruker Instruments	343	IBRD/IDA
Unspecified	Cincinnati Milacron Marketing Co.	505	ADB
Unspecified	Finnegan Materials	212	IBRD/IDA
Unspecified	Sheila M. Stanton	22	IBRD/IDA
Unspecified	Undetermined	5,027	IBRD/IDA
Unspecified	Undetermined	681	ADB
Waltham	Electronic Data Systems Corp.	16	EBRD
Waltham	GTE Spacenet Int'l Corp.	141	IBRD/IDA
Waltham	Simat, Helliesen & Eichner	33	EBRD
West Dennis	Susan Greeley	11	EBRD
Westboro	Data General Corp.	171	IBRD/IDA
Weymouth	Fisher-Pierce	164	IDB
State Total		148,444	

MICHIGAN

CITY	COMPANY	AMOUNT ($'000)	BANK
Baraga	Pettibone Michigan Corp.	84	IBRD/IDA
Battle Creek	Clark Equipment Co.	195	IBRD/IDA
Detroit	DIFCO Laboratories Inc.	10	IDB
Detroit	Ford Motor Co.	6,194	IBRD/IDA
Detroit	General Motors Corp.	77,880	EBRD
Detroit	General Motors Corp.	1,244	IBRD/IDA
Detroit	General Motors Corp.	822	IBRD/IDA
Detroit	General Motors Corp.	56	IBRD/IDA
Detroit	General Motors Overseas Corp.	571	IBRD/IDA
Detroit	General Motors Overseas Corp.	231	IBRD/IDA
Detroit	General Motors Overseas Corp.	138	IDB
Detroit	Siemens	1,298	IBRD/IDA
Detroit	Unisys Corp.	36	IDB
Detroit	Unisys Corp.	6	IDB
Detroit	Unisys Int'l Trading	154	IBRD/IDA
Detroit	Wright Austin Company	109	ADB
Kalamazoo	Upjohn Worldwide	125	IBRD/IDA
Livonia	E&C Associates	8	IIC
Ludington	Pandrol Jackson	4,789	IBRD/IDA
Manchester	Johnson Controls Inc.	398	IBRD/IDA
Plymouth	Rickert Precision Inds Inc.	794	ADB
Plymouth	Rickert Precision Inds Inc.	206	ADB

MICHIGAN

CITY	COMPANY	AMOUNT ($'000)	BANK
Rochester Hills	Virtual Technology Inc.	33	IDB
Saginaw	Saginaw Division Inc.	382	IBRD/IDA
Southfield	Dailey R. E. & Co.	153	IBRD/IDA
Southfield	DSA of America Inc.	1,941	IBRD/IDA
Tecumseh	Tecumseh Product Co.	196	IBRD/IDA
Unspecified	L. Agan	33	IBRD/IDA
Unspecified	Undetermined	2,982	IBRD/IDA
Unspecified	Undetermined	52	ADB
Whitebear	Schwing America Inc.	191	IBRD/IDA
State Total		101,311	

MINNESOTA

CITY	COMPANY	AMOUNT ($'000)	BANK
Bloomington	Control Data China Inc.	733	IBRD/IDA
Bloomington	Control Data China Inc.	314	IBRD/IDA
Eagan	Check Technology Corp.	91	IBRD/IDA
Eden Prairie	MTS Systems Corp.	553	IBRD/IDA
Minneapolis	Cargill Inc.	9,997	IBRD/IDA
Minneapolis	Cargill Inc.	467	AFDB
Minneapolis	Carter Day Int'l	175	IDB
Minneapolis	Control Data Corp.	10,739	IBRD/IDA
Minneapolis	Control Data Corp.	412	IBRD/IDA
Minneapolis	Detector Electronic Corp.	89	IBRD/IDA
Minneapolis	Elke Corp.	81	IBRD/IDA
Minneapolis	Geoffrey Ferster	24	ADB
Minneapolis	Honeywell Inc.	1,000	MIGA
Minneapolis	Minnesota Valley Engineering	231	IBRD/IDA
Minneapolis	Minnesota Valley Engineering	76	ADB
Minneapolis	MTS Systems Corp.	1,257	IBRD/IDA
Minneapolis	MTS Systems Corp.	726	IBRD/IDA
Minneapolis	MTS Systems Corp.	384	IBRD/IDA
Minneapolis	National Computer Systems	208	IBRD/IDA
Minneapolis	Siemans - Empros Systems Int'l	3,732	IDB
Minneapolis	Siemans - Empros Systems Int'l	1,420	IBRD/IDA
Minneapolis	Siemans - Empros Systems Int'l	863	IBRD/IDA

MINNESOTA

CITY	COMPANY	AMOUNT ($'000)	BANK
Minneapolis	Siemans - Empros Systems Int'l	249	IBRD/IDA
Mound	Allan West Consulting Services	10	IIC
St. Paul	Fairmont Railway Motors Inc.	4,810	IBRD/IDA
St. Paul	Harvest States Coop.	2,308	IBRD/IDA
St. Paul	Minnesota Mining & Manufacturing Corp.	1,058	IBRD/IDA
St. Paul	Minnesota Mining & Manufacturing Corp.	27	IDB
St. Paul	Minnesota Mining & Manufacturing Corp.	3	IDB
Unspecified	General Signal Corp.	193	IBRD/IDA
Unspecified	Undetermined	5,706	IBRD/IDA
Unspecified	Undetermined	2,797	ADB
Woodbury	IBM Corp.	150	IBRD/IDA
State Total		50,883	

MISSISSIPPI

CITY	COMPANY	AMOUNT ($'000)	BANK
Laurel	Howard Industries Inc.	3,540	IDB
Unspecified	Bill Gregg	7	IBRD/IDA
Unspecified	Charles L. Sciple	4	IBRD/IDA
Unspecified	Tri-State Pole & Piling Inc.	1,216	IBRD/IDA
Unspecified	Tri-State Pole & Piling Inc.	745	IBRD/IDA
Unspecified	Tri-State Pole & Piling Inc.	68	IBRD/IDA
Unspecified	Tri-State Pole & Piling Inc.	11	IBRD/IDA
Unspecified	Undetermined	79	IBRD/IDA
State Total		5,670	

MISSOURI

CITY	COMPANY	AMOUNT ($'000)	BANK
Bowling Green	Cecil C. Daffron & Associates Inc.	369	IBRD/IDA
Centralia	AB Chance Co.	5,475	IBRD/IDA
Centralia	AB Chance Co.	2,634	ADB
Centralia	AB Chance Co.	490	IDB
Centralia	AB Chance Co.	391	IDB
Centralia	AB Chance Co.	356	ADB
Centralia	AB Chance Co.	171	IDB
Centralia	AB Chance Co.	35	IDB
Centralia	White - Safeguard America Inc.	42	IDB
Kansas City	Black & Veatch Int'l Co.	9,894	IBRD/IDA
Kansas City	Black & Veatch Int'l Co.	9,077	IBRD/IDA
Kansas City	Black & Veatch Int'l Co.	3,666	IBRD/IDA
Kansas City	Black & Veatch Int'l Co.	2,413	IBRD/IDA
Kansas City	Black & Veatch Int'l Co.	1,500	IBRD/IDA
Kansas City	Black & Veatch Int'l Co.	1,075	AFDB
Kansas City	Black & Veatch Int'l Co.	470	IBRD/IDA
Kansas City	Farmland Industries Inc.	7,903	IBRD/IDA
Kansas City	Labconco Co.	43	IDB
Mexico	A.P. Green Industries	621	IBRD/IDA
Springfield	Int'l Division Inc.	3,593	IBRD/IDA
St. Louis	China Capital Development Corp.	540	MIGA
St. Louis	Cooper Bussman	182	IDB

MISSOURI

CITY	COMPANY	AMOUNT ($'000)	BANK
St. Louis	Diversified Metals Corp.	175	IBRD/IDA
St. Louis	Fulton Iron Works Co.	142	IBRD/IDA
St. Louis	General Motors Corp.	52	IDB
St. Louis	Monsanto Co.	1,103	IBRD/IDA
St. Louis	Monsanto Int'l Sales Co.	7,728	IBRD/IDA
St. Louis	Monsanto Int'l Sales Co.	132	IBRD/IDA
St. Louis	Power Line Hardware	166	IDB
St. Louis	Sigma Chemical Co.	341	IBRD/IDA
St. Louis	Sigma Chemical Co.	26	IDB
St. Louis	Sigma Chemical Co.	8	AFDB
St. Louis	Sunnen Products Co.	2,700	MIGA
St. Louis	Washington University in St. Louis	13	AFDB
Unspecified	Undetermined	3,181	IBRD/IDA
Washington	Pauvels Transformers	720	IDB
Washington	Undetermined	660	ADB
State Total		68,087	

NEBRASKA

CITY	COMPANY	AMOUNT ($'000)	BANK
Lincoln	Mid-America Int'l Agricultural Consortium	676	IBRD/IDA
Omaha	AGP Grain Cooperative	4,953	IBRD/IDA
Omaha	AGP Grain Cooperative	2,321	IBRD/IDA
Omaha	AGP Grain Cooperative	2,312	IBRD/IDA
Unspecified	Undetermined	521	IBRD/IDA
Valley	Valmont Industries Inc.	3,685	IBRD/IDA
Waverly	National Crane	172	IDB
State Total		14,640	

NEVADA

CITY	COMPANY	AMOUNT ($'000)	BANK
Reno	Globe Turbo Charger	9	IBRD/IDA
Unspecified	Hunt Spiller	238	IBRD/IDA
State Total		247	

NEW HAMPSHIRE

CITY	COMPANY	AMOUNT ($'000)	BANK
Dover	Harris Graphics Corp.	302	IBRD/IDA
Dublin	Sally Warren	131	EBRD
Manchester	Burndy Corp Int'l Trade Group	42	ADB
Unspecified	Hyundai-Smith Norrington	679	IBRD/IDA
Unspecified	Undetermined	2,522	IBRD/IDA
State Total		3,676	

NEW JERSEY

CITY	COMPANY	AMOUNT ($'000)	BANK
Basking Ridge	AT&T Int'l Inc.	1,360	IFC
Bayonne	Indusco Ltd	417	IDB
Berkeley Heights	AT&T Int'l Inc.	3,059	ADB
Berkeley Heights	AT&T Int'l Inc.	1,080	IDB
Berkeley Heights	Mita Copystar America Inc.	182	IBRD/IDA
Bloomfield	ABB Lummus Crest Inc.	260	IBRD/IDA
Bridgewater	Baker & Taylor	355	IBRD/IDA
Chatham	Interconsult	57	EBRD
Cherry Hill	General Electric Int'l Service Co.	835	IBRD/IDA
Cherry Hill	General Electric Int'l Service Co.	521	IBRD/IDA
Cherry Hill	Serco Education Ltd	1,939	IBRD/IDA
Cherry Hill	Serco Education Ltd	1,702	IBRD/IDA
Cherry Hill	Serco Education Ltd	906	IBRD/IDA
Cherry Hill	Serco Education Ltd	906	IBRD/IDA
Cherry Hill	Serco Education Ltd	346	IBRD/IDA
Cherry Hill	Siemens Corp.	713	IBRD/IDA
Clifton	Roche	147	IBRD/IDA
Clinton	Foster Wheeler Energy Corp.	845	IDB
Clinton	Foster Wheeler Energy Corp.	375	IDB
East Hanover	Royal Lubricants Co.	172	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	10,411	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	6,928	IBRD/IDA

NEW JERSEY

CITY	COMPANY	AMOUNT ($'000)	BANK
East Orange	Louis Berger Int'l Inc.	5,601	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	5,016	AFDB
East Orange	Louis Berger Int'l Inc.	4,835	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	3,176	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	2,952	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	1,926	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	1,811	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	1,499	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	1,494	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	1,209	ADB
East Orange	Louis Berger Int'l Inc.	1,099	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	940	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	721	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	703	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	563	ADB
East Orange	Louis Berger Int'l Inc.	541	ADB
East Orange	Louis Berger Int'l Inc.	484	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	448	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	284	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	280	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	160	ADB
East Orange	Louis Berger Int'l Inc.	150	IDB

NEW JERSEY

CITY	COMPANY	AMOUNT ($'000)	BANK
East Orange	Louis Berger Int'l Inc.	68	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	61	IBRD/IDA
East Orange	Louis Berger Int'l Inc.	1	IBRD/IDA
East Rutherford	Dealers Audio-Visual	65	IDB
Elmwood	Tricon Associates	132	IBRD/IDA
Englewood Cliffs	Clinton Bogert Associates	2,500	IDB
Englewood Cliffs	Irridelco Int'l	504	IBRD/IDA
Englewood Cliffs	Summit Engineering & Research Corp.	259	AFDB
Farmingdale	Lab-Volt Systems	647	IBRD/IDA
Farmingdale	Lab-Volt Systems	380	IBRD/IDA
Farmingdale	Lab-Volt Systems	237	IBRD/IDA
Florham Park	Esso Eastern Products & Trading	4,942	IBRD/IDA
Florham Park	Ohaus Corp.	81	ADF
Florham Park	Ohaus Corp.	3	IDB
Fort Lee	Machinpex America Inc.	52	ADB
Hackensack	Vitusa Corp.	262	IBRD/IDA
Hazlet	Int'l Flavors	479	IBRD/IDA
Hightstown	PA Consulting Group Inc.	247	IBRD/IDA
Iselin	Alliance Grain Inc.	1,178	IBRD/IDA
Iselin	Engelhood Corp.	356	IBRD/IDA
Livingston	Foster Wheeler Energy Corp.	15,384	IBRD/IDA
Livingston	Foster Wheeler Energy Corp.	534	IBRD/IDA

NEW JERSEY

CITY	COMPANY	AMOUNT ($'000)	BANK
Livingston	Foster Wheeler Energy Corp.	198	IBRD/IDA
Montvale	Datascope Corp.	194	IDB
Moorestown	Telesciences Inc.	1,901	IFC
Morris City	Continental Distrib. Inc.	67	IDB
Morristown	Ardy Trading Co.	379	ADB
Morristown	Ardy Trading Co.	56	ADB
Morristown	Ardy Trading Co.	44	ADB
Morristown	Ardy Trading Co.	2	ADB
Morristown	Fisher Scientific	175	IBRD/IDA
Newark	Ameritrade Int'l Inc.	103	ADB
Newark	Ameritrade Int'l Inc.	74	ADB
Newark	Brown Swiss Corp.	962	IBRD/IDA
Newark	Gantrade Corp.	153	IBRD/IDA
Newark	Inductotherm	232	IBRD/IDA
Newark	Merck Sharp & Dohme Int'l	207	IBRD/IDA
Newark	National Economic Research Assoc.	682	IBRD/IDA
Newark	National Economic Research Assoc.	290	IBRD/IDA
Newark	Quad System Corp.	699	IBRD/IDA
Old Bridge	Wotek Corp.	911	IBRD/IDA
Oradell	Burns & Roe Co.	419	ADB
Oradell	Burns & Roe Co.	95	ADB
Oradell	K. K. Int'l Inc.	402	IBRD/IDA

NEW JERSEY

CITY	COMPANY	AMOUNT ($'000)	BANK
Orange	Hockman Lewis Ltd	119	'BRD/IDA
Paramus	Posshel Inc.	343	IBRD/IDA
Piscataway	Helm New York Chemical Corp.	136	IBRD/IDA
Piscataway	Ingersoll Rand Int'l Sales Inc.	2,004	ADB
Piscataway	Ingersoll Rand Int'l Sales Inc.	284	IBRD/IDA
Piscataway	Ingersoll Rand Int'l Sales Inc.	181	IBRD/IDA
Pisea	Ingersoll Rand Int'l Sales Inc.	174	AFDB
Plainfield	VWR Scientific Corp.	55	IDB
Plainfield	VWR Scientific Corp.	6	ADF
Plainfield	Winston Riley III	6	IDB
Princeton	Coda & Partners	389	AFDB
Princeton	EG&G Applied Research	307	IBRD/IDA
Princeton	Hewitt Associates	518	ADB
Princeton	Stanford Research Int'l - Peter Davis	40	EBRD
Princeton	Techne Inc.	3	IDB
Ridgefield Park	Auto-Graphica Export Corp.	181	IBRD/IDA
Ridgewood	Dun & Bradstreet Corp.	3,000	EBRD
Rutherford	National Audio Visual Supply	366	IBRD/IDA
Saddle Brook	Espic	106	IBRD/IDA
Sommerville	Ethicon Inc.	454	IBRD/IDA
Springfield	Fischer Scientific	13	IDB
Springfield	Fisher Scientific	81	IDB

NEW JERSEY

CITY	COMPANY	AMOUNT ($'000)	BANK
Springfield	Fisher Scientific	55	IDB
Springfield	Fisher Scientific	30	IDB
Trenton	Geometric Machine & Design	824	IBRD/IDA
Trenton	Imo Industries Inc.	2,397	ADB
Union	Electrocatalytic Inc.	166	IBRD/IDA
Union	Senior Boiler Tube Co.	248	IDB
Unspecified	Craden	3	IBRD/IDA
Unspecified	Lexington Switch & Controls	117	IBRD/IDA
Unspecified	Nubenco	74	IBRD/IDA
Unspecified	Undetermined	22,653	IBRD/IDA
Unspecified	Undetermined	170	ADB
Vineland	Vineland Laboratories	15	ADF
Vorhees	Alliance Grain Inc.	1,178	IBRD/IDA
Washington	Ingersoll Rand Co.	36	IDB
Wayne	American Cyanamid Co.	859	IBRD/IDA
Wayne	American Cyanamid Co.	219	IBRD/IDA
Wayne	American Cyanamid Co.	123	IBRD/IDA
Weehawken	Bittern Int'l	58	AFDB
Whitehouse Station	Merck & Sharp Co.	122	AFDB
State Total		144,138	

NEW MEXICO

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Erik D. Schwoebel	40	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
Albany	Simmons Machine Tools Corp.	4,509	IBRD/IDA
Albany	Simmons Machine Tools Corp.	1,202	IBRD/IDA
Albany	Simmons Machine Tools Corp.	1,101	IBRD/IDA
Albany	Simmons Machine Tools Corp.	659	IBRD/IDA
Albany	Simmons Machine Tools Corp.	601	IBRD/IDA
Angola	TXRX System	3	IDB
Arcade	K.N. Aronson Inc.	38	IDB
Ardsley	Ciba-Geigy Export Sales Corp.	316	IBRD/IDA
Ballstone	Turbine Supplies	2,579	IDB
Binghamton	Institute for Development Anthropology	30	IDB
Brownsville	D.T.S. Inc.	128	IBRD/IDA
Buffalo	Corning Inc.	4	IDB
Cambridge	Thinking Machines Corp.	1,125	IBRD/IDA
Corning	Corning Inc.	360	IBRD/IDA
Corning	Corning Inc.	308	IBRD/IDA
Cutchogue	Aiello Enterprises Ltd	149	EBRD
Dansville	Foster Wheeler Energy Corp.	35,040	IBRD/IDA
Elmira	Garlock Inc.	243	IDB
Elmsford	EDT Technology Corp.	213	IBRD/IDA
Genova	Anwar A. Khan	13	IDB
Hauppage	Satellite Transmission Systems Inc.	3,981	EBRD
Hauppage	Satellite Transmission Systems Inc.	3,800	EBRD

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
Hauppage	Satellite Transmission Systems Inc.	1,264	IBRD/IDA
Hudson Falls	General Electric Co.	11,553	IBRD/IDA
Ithaca	Cornell University	386	IBRD/IDA
Ithaca	Cornell University	201	IBRD/IDA
Lancaster	Ecology & Environment Inc.	725	IBRD/IDA
Lancaster	Ecology & Environment Inc.	401	IBRD/IDA
Lancaster	Ecology & Environment Inc.	100	IBRD/IDA
Le Roy	Lapp Insulator Co.	1,530	IBRD/IDA
Le Roy	Lapp Insulator Co.	716	IDB
Le Roy	Lapp Insulator Co.	545	ADB
Le Roy	Lapp Insulator Co.	230	IBRD/IDA
Long Island	Mollendo Equipment Co.	241	IDB
Long Island	Mollendo Equipment Co.	48	IDB
Massena	Greyline Instruments	272	IDB
Melville	ABB Power Automation Inc.	1,536	IBRD/IDA
Melville	ABB Power Automation Inc.	1,047	IBRD/IDA
Melville	ABB Power Automation Inc.	382	IBRD/IDA
Merrick	Fluid Data Inc.	1,620	IBRD/IDA
Merrick	Fluid Data Inc.	231	IBRD/IDA
Morristown	Allied Signal Inc.	3,748	IBRD/IDA
New Rochelle	Techcast Industries Inc.	121	IBRD/IDA
New York City	Abal Int'l Ltd	2,611	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Abal Int'l Ltd	1,301	IBRD/IDA
New York City	Accutrol Inc.	75	ADB
New York City	Alan L. Grant Rubber Div.	6,992	IBRD/IDA
New York City	Alliance Capital Management Corp.	15,100	EBRD
New York City	Alliance Capital Management Corp.	15,000	EBRD
New York City	American Natural Soda Ash	115	IBRD/IDA
New York City	American Petrochemical	254	IBRD/IDA
New York City	Ansul Fire Int'l	217	IBRD/IDA
New York City	Arco Chemical Co.	135	IBRD/IDA
New York City	Banco Do Brasil	225	IBRD/IDA
New York City	Bankers Trust	20,000	EBRD
New York City	Bankers Trust	253	IBRD/IDA
New York City	Bastignoles	1,814	IBRD/IDA
New York City	Booz, Allen & Hamilton Inc.	523	IDB
New York City	Booz, Allen & Hamilton Inc.	222	IBRD/IDA
New York City	Booz, Allen & Hamilton Inc.	213	IBRD/IDA
New York City	Booz, Allen & Hamilton Int'l Inc.	1,246	IBRD/IDA
New York City	Booz, Allen & Hamilton Int'l Inc.	1,105	IBRD/IDA
New York City	Booz, Allen & Hamilton Int'l Inc.	349	IBRD/IDA
New York City	Brookhaven Instruments Co.	75	IDB
New York City	Bunge Corp.	255	IBRD/IDA
New York City	Caltex Overseas Ltd	5,223	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Care Int'l	37	IDB
New York City	Center for Int'l Health & Cooperation	244	AFDB
New York City	Central European Development Corp.	11,000	EBRD
New York City	Central European Development Corp.	8,000	EBRD
New York City	Cessna Aircraft Co.	300	IBRD/IDA
New York City	Chase Manhattan Bank	20,000	IFC
New York City	Chem Systems Inc.	245	IBRD/IDA
New York City	Cheminter Delaware Inc.	104	IBRD/IDA
New York City	Chentex Int'l Inc.	20	EBRD
New York City	China Trade Ind. Services	215	IBRD/IDA
New York City	Citibank, N.A.	41,400	MIGA
New York City	Citibank, N.A.	20,000	EBRD
New York City	Citibank, N.A.	7,400	MIGA
New York City	Citibank, N.A.	2,300	MIGA
New York City	Coinsa S. A.	139	IBRD/IDA
New York City	Colombia School of Int'l & Public Affairs	8	AFDB
New York City	Combustion Engineering Inc.	2,887	IBRD/IDA
New York City	Combustion Engineering Inc.	507	IBRD/IDA
New York City	COMSERTEC	28	IBRD/IDA
New York City	Continental Enterprises Ltd	3,793	MIGA
New York City	Continental Enterprises Ltd	765	MIGA
New York City	Continental Grain Co.	4,627	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Continental Grain Co.	347	IBRD/IDA
New York City	Conti-Quincy Export Co.	1,221	IBRD/IDA
New York City	Coopers & Lybrand	658	IBRD/IDA
New York City	Coopers & Lybrand	181	IBRD/IDA
New York City	Coopers & Lybrand	115	IIC
New York City	Czech American Enterprise Fund	7,400	EBRD
New York City	C. Czarnikow Inc.	129	IDB
New York City	C. Itoh & Co.	1,692	IBRD/IDA
New York City	C. Itoh & Co.	166	IBRD/IDA
New York City	Dalton & Cooper & Gates Corp.	774	IBRD/IDA
New York City	Data General Corp.	930	IBRD/IDA
New York City	Data General Corp.	172	IBRD/IDA
New York City	Dekalb Genetics	851	IBRD/IDA
New York City	Deloitte Touche & Co.	1,890	IBRD/IDA
New York City	Deloitte Touche & Co.	304	IBRD/IDA
New York City	Diamond Fertilizer & Chemical	102	IBRD/IDA
New York City	Door Oliver Inc.	368	IBRD/IDA
New York City	D.J. Giancola Exports Inc.	105	IDB
New York City	EBASCO Overseas Corp.	582	IBRD/IDA
New York City	EBASCO Overseas Corp.	439	IBRD/IDA
New York City	EBASCO Overseas Corp.	227	IBRD/IDA
New York City	EBASCO Overseas Corp.	67	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Echelon Int'l Inc.	115	IBRD/IDA
New York City	Elof Hanson Pulp Inc.	7,094	IBRD/IDA
New York City	Elof Hanson Pulp Inc.	504	IBRD/IDA
New York City	Enimont America Inc.	822	IBRD/IDA
New York City	Ernst & Young Int'l	500	IDB
New York City	Ernst & Young Int'l	179	IDB
New York City	Ernst & Young Int'l	28	IDB
New York City	Ferrex Int'l Inc.	28	ADB
New York City	Ferruzzi Trading	4,785	IBRD/IDA
New York City	Fiber Industries	576	IBRD/IDA
New York City	First Boston Corp.	131	IBRD/IDA
New York City	Frederic R. Harris Inc.	706	IDB
New York City	Frederic R. Harris Inc.	375	IDB
New York City	Frederic R. Harris Inc.	275	IDB
New York City	Frederic R. Harris Inc.	100	IDB
New York City	General Electric Co.	11,351	IBRD/IDA
New York City	General Electric Co.	5,449	IDB
New York City	General Motors Corp.	255	IBRD/IDA
New York City	General Radio Co.	39	IDB
New York City	Gentrade Corp.	2,356	IBRD/IDA
New York City	George McFadden & Brothers Inc.	186	IBRD/IDA
New York City	Han-Padron Assoc.	255	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Hewlett Packard Co.	176	IBRD/IDA
New York City	Hewlett Packard Co.	141	IBRD/IDA
New York City	Hillandale Sales Corp.	800	IBRD/IDA
New York City	Hoechst Celanese Corp.	299	IBRD/IDA
New York City	Hugo Neu & Sons	4,086	ADB
New York City	Hugo Neu & Sons	3,287	IBRD/IDA
New York City	H.J. Baker & Bros. Inc.	7,256	IBRD/IDA
New York City	IBM World Trade Corp.	204	IDB
New York City	ICI America	556	IBRD/IDA
New York City	Ingersoll Rand Co.	978	IBRD/IDA
New York City	Ingersoll Rand Co.	108	IBRD/IDA
New York City	Institute of Int'l Education	126	IBRD/IDA
New York City	Institute of Public Administration	2,816	IBRD/IDA
New York City	Institute of Public Administration	846	IBRD/IDA
New York City	Inter Quise - Inter-Continental	128	IBRD/IDA
New York City	Inter-Continental Inc.	115	ADB
New York City	Int'l Business & Technology Consultants Inc.	132	IBRD/IDA
New York City	Int'l Commodities Export Corp.	3,766	IBRD/IDA
New York City	Int'l Grain Trade Inc.	251	IBRD/IDA
New York City	Int'l Securities Clearing	29	EBRD
New York City	Int'l Swap Dealers Association	40,000	IFC
New York City	James Capel Inc.	3,995	IFC

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Jeanne Schoenberger	15	EBRD
New York City	J.P. Morgan Capital Corp.	45,000	IFC
New York City	Kraftcorp	571	IBRD/IDA
New York City	Leborg	3,135	IBRD/IDA
New York City	Liberty Machinery	609	IBRD/IDA
New York City	Louis Berger Int'l Inc.	615	ADB
New York City	Louis Berger Int'l Inc.	367	ADB
New York City	Lubrizol Corp.	1,172	IBRD/IDA
New York City	Lummus-Techint Inc.	163	IBRD/IDA
New York City	Massive Int'l Inc.	213	IBRD/IDA
New York City	McKinsey & Co.	866	IBRD/IDA
New York City	McKinsey & Co.	98	IBRD/IDA
New York City	Mercer Management Consulting Inc.	213	EBRD
New York City	Michael Turek	8	EBRD
New York City	Michael Turek	1	EBRD
New York City	Miles Metal Co.	902	IBRD/IDA
New York City	Mitsubishi Int'l Corp.	504	IBRD/IDA
New York City	Mitsui & Co.	4,876	ADB
New York City	Mitsui & Co.	4,300	ADB
New York City	Mobil Oil Co. Int'l	4,951	IBRD/IDA
New York City	Montgomery Marshall & Co.	149	IBRD/IDA
New York City	Network Dynamics Associates	61	EBRD

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Network Dynamics Associates	48	EBRD
New York City	New World Research Corp.	1,427	IBRD/IDA
New York City	New World Research Corp.	48	IBRD/IDA
New York City	New World Research Corp.	12	IDB
New York City	New York Life	10,186	IFC
New York City	Newco AG	265	IBRD/IDA
New York City	Ogilvy & Mather	188	IBRD/IDA
New York City	Omega Int'l Inc.	197	IBRD/IDA
New York City	Paine Webber Inc.	25	EBRD
New York City	Papex Exporters	972	IBRD/IDA
New York City	Parsons Brinckerhoff Int'l Inc.	636	IBRD/IDA
New York City	Pasternak, Baum Int'l Inc.	2,493	IBRD/IDA
New York City	Polish American Enterprise Fund	50,000	EBRD
New York City	Polish American Enterprise Fund	2,200	EBRD
New York City	Population Council	696	ADB
New York City	Power Technologies Inc.	72	ADF
New York City	Price Waterhouse Int'l	2,961	IBRD/IDA
New York City	Price Waterhouse Int'l	1,205	IBRD/IDA
New York City	Price Waterhouse Int'l	457	IBRD/IDA
New York City	Pride Int'l	365	IBRD/IDA
New York City	Quali Mix Int'l Co., Ltd	400	IBRD/IDA
New York City	Quali Mix Int'l Co., Ltd	179	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Redcom Laboratories Inc.	101	ADF
New York City	Rockefeller & Co.	25,000	IFC
New York City	Rockefeller & Co.	2,810	IFC
New York City	Satellite Transmission Systems Inc.	3,138	IBRD/IDA
New York City	Satellite Transmission Systems Inc.	399	IBRD/IDA
New York City	Shea & Gould	40	EBRD
New York City	Sino-American Corp.	8,345	IBRD/IDA
New York City	Sino-American Corp.	441	IBRD/IDA
New York City	Socimer Int'l Inc.	11	IIC
New York City	Sogerm Corp.	122	IBRD/IDA
New York City	Sonal Enterprises	24	ADB
New York City	Sonic Environment Systems	14	AFDB
New York City	Soros Associates	425	IBRD/IDA
New York City	Soros Associates	101	IBRD/IDA
New York City	Soros Associates	100	IBRD/IDA
New York City	Steinman, Boynton, Gronquist, & Birdsall	4,122	IBRD/IDA
New York City	Steinman, Boynton, Gronquist, & Birdsall	1,500	IDB
New York City	Steinman, Boynton, Gronquist, & Birdsall	1,500	IDB
New York City	Steinman, Boynton, Gronquist, & Birdsall	532	IBRD/IDA
New York City	Steinman, Boynton, Gronquist, & Birdsall	250	IBRD/IDA
New York City	Steinman, Boynton, Gronquist, & Birdsall	189	IBRD/IDA
New York City	Stemcor USA Inc.	402	IDB

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Stone & Webster Management Consult.	858	IBRD/IDA
New York City	Stone & Webster Management Consult.	761	IBRD/IDA
New York City	Stone & Webster Overseas	88	IBRD/IDA
New York City	Sumitomo Corp. of America	9,549	IBRD/IDA
New York City	Sumitomo Corp. of America	7,796	IBRD/IDA
New York City	Sumitomo Corp. of America	2,100	IBRD/IDA
New York City	TAMS Consultants Inc.	2,845	IBRD/IDA
New York City	TAMS Consultants Inc.	2,455	AFDB
New York City	TAMS Consultants Inc.	800	IBRD/IDA
New York City	TAMS Consultants Inc.	724	IBRD/IDA
New York City	TAMS Consultants Inc.	455	IBRD/IDA
New York City	TAMS Consultants Inc.	162	IBRD/IDA
New York City	TAMS Consultants Inc.	102	IBRD/IDA
New York City	Tata - Honeywell	417	IBRD/IDA
New York City	Tata - Unisys Ltd	281	IBRD/IDA
New York City	Techint Inc.	869	IBRD/IDA
New York City	Techint Inc.	820	IBRD/IDA
New York City	Teledyne Gurley	232	IBRD/IDA
New York City	Transamonnia	2,274	IBRD/IDA
New York City	Transamonnia	1,966	ADB
New York City	Transamonnia	1,419	IBRD/IDA
New York City	Tugman-Nash Inc.	204	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
New York City	Union Bank of Switzerland	5,700	MIGA
New York City	Union Carbide Corp.	1,345	IBRD/IDA
New York City	Vermeck Southeast Sales	585	IBRD/IDA
New York City	Vima Trading Co.	168	IBRD/IDA
New York City	Westinghouse	515	IBRD/IDA
New York City	Whitehall Boyle Int'l	134	IBRD/IDA
New York City	William J. Chechter Corp.	132	IBRD/IDA
New York City	World Fibre Prod.	846	IBRD/IDA
Oyster Bay	Sealift Bulkers Inc.	765	IBRD/IDA
Plattsburgh	McConnell Manufacturing	41	IDB
Poestenkill	Duffers Scientific Corp. Inc.	402	IBRD/IDA
Purchase	Int'l Paper Co.	52,800	EBRD
Purchase	Int'l Paper Co.	52,750	EBRD
Purchase	Int'l Paper Co.	34,000	EBRD
Purchase	Int'l Paper Co.	24,000	IFC
Rochester	Eastman Kodak Co.	1,888	IBRD/IDA
Rochester	Eastman Kodak Co.	2	IDB
Rochester	Gleason Works	989	IBRD/IDA
Rochester	Gleason Works	849	ADB
Rochester	Rochester Instrument Systems	812	IDB
Rochester	Rochester Instrument Systems	129	IDB
Rye	IBM World Trade Corp.	2,361	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
Scarsdale	Delrohm Int'l Ltd	1,012	IBRD/IDA
Scarsdale	Unit House Machinery Co.	681	IBRD/IDA
Schenectady	General Electric Co.	13,934	IBRD/IDA
Schenectady	General Electric Co.	4,749	IBRD/IDA
Schenectady	General Electric Co.	510	IBRD/IDA
Schenectady	Power Technologies Inc.	117	IBRD/IDA
Schenectady	Power Technologies Inc.	12	IDB
Seneca Falls	Goulds Pumps Inc.	2,378	ADB
Seneca Falls	Goulds Pumps Inc.	640	IBRD/IDA
Seneca Falls	Goulds Pumps Inc.	109	IBRD/IDA
Seneca Falls	Hazta Industrial Corp.	1,274	IBRD/IDA
Seneca Falls	Hazta Industrial Corp.	160	IBRD/IDA
Stony Brook	Dynamic Control Systems	154	IDB
Syracuse	Carrier Int'l Corp.	208	IBRD/IDA
Syracuse	Crouse Hinds	29	IBRD/IDA
Syracuse	De Giancola Exports	105	IBRD/IDA
Syracuse	Energy Investors Fund	8,100	MIGA
Syracuse	Hydra-Co. Enterprises Inc.	25,500	MIGA
Syracuse	Int'l Energy Partners	2,600	MIGA
Syracuse	Rockfort Power Associates	12,500	MIGA
Syracuse	Rotork Controls Inc.	133	IBRD/IDA
Syracuse	USEC-Precursor Inc.	1,300	MIGA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
Tarrytown	IBM World Trade Corp.	26,348	IBRD/IDA
Tonawanda	American Allsafe Co.	11	IDB
Troy	Ross Valve Mfg. Co.	153	IDB
Unspecified	Atlantic Kraft Corp.	305	IBRD/IDA
Unspecified	Baker & Taylor	283	IBRD/IDA
Unspecified	Bamberger Polymers Int'l	136	IBRD/IDA
Unspecified	Bruce F. Henderson	295	IBRD/IDA
Unspecified	Casystems Int'l Inc.	160	IBRD/IDA
Unspecified	Charles DeSallien	25	IBRD/IDA
Unspecified	Charles H. Sells Inc.	275	IBRD/IDA
Unspecified	Claire Wilbur	14	IBRD/IDA
Unspecified	Clarendon Ltd	6,932	IBRD/IDA
Unspecified	C. Warren Goelz	13	IBRD/IDA
Unspecified	Edospina	172	IBRD/IDA
Unspecified	Elsinco	107	IBRD/IDA
Unspecified	Globus Mercantile Co.	184	IBRD/IDA
Unspecified	Heinzel Import Export Inc.	1,257	IBRD/IDA
Unspecified	Honeywell Inc.	24	IBRD/IDA
Unspecified	James W. Guthrie	14	IBRD/IDA
Unspecified	Jigjid Unenbat	15	IBRD/IDA
Unspecified	John R. Chirichiello	109	IBRD/IDA
Unspecified	J. Aron & Co.	23,265	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	J. Aron & Co.	4,659	IBRD/IDA
Unspecified	Landmark Graphics Corp.	303	IBRD/IDA
Unspecified	Management Sciences for Health	49	IBRD/IDA
Unspecified	Michael Anderson	75	IBRD/IDA
Unspecified	Petrochem Dev. Co.	230	IBRD/IDA
Unspecified	Philip Morris Inc.	1,763	IBRD/IDA
Unspecified	Philipp Brothers	634	IBRD/IDA
Unspecified	Prolab Sales Inc.	1,176	IBRD/IDA
Unspecified	Quantum Precision Inc.	569	IBRD/IDA
Unspecified	Robert Pleasant	89	IBRD/IDA
Unspecified	Schenck Pegasus Corp.	981	IBRD/IDA
Unspecified	Schnell Enterprises	103	IBRD/IDA
Unspecified	Scientific Design Co.	406	IBRD/IDA
Unspecified	Scientific Design Co.	203	IBRD/IDA
Unspecified	Technoserve	50	IBRD/IDA
Unspecified	Textronix Inc.	60	IBRD/IDA
Unspecified	Tradeway Int'l Corp.	2,315	IBRD/IDA
Unspecified	Tradeway Int'l Corp.	465	IBRD/IDA
Unspecified	Undetermined	59,519	IBRD/IDA
Unspecified	Undetermined	3,147	ADB
Unspecified	Vanderburgh & Co.	189	IBRD/IDA
Unspecified	Wabashy Electrical Products	33	IBRD/IDA

NEW YORK

CITY	COMPANY	AMOUNT ($'000)	BANK
Utica	Laser Precision Corp.	55	ADB
Wappingers Falls	Decision Technologies	69	IBRD/IDA
Warwick	BIF	1,500	IDB
Wellesville	ABB Air Preheater Inc.	2,185	IBRD/IDA
Wellesville	ABB Air Preheater Inc.	673	IBRD/IDA
Wellesville	Air Preheater Co.	109	IDB
Westchester	Armstrong Engineering Assoc.	1,103	IBRD/IDA
White Plains	IBM Inc.	132	IDB
White Plains	King America Corp.	336	ADB
White Plains	King America Corp.	290	ADB
White Plains	King America Corp.	172	ADB
White Plains	King America Corp.	156	ADB
White Plains	King America Corp.	69	ADB
White Plains	King America Corp.	16	ADB
White Plains	King America Corp.	12	ADB
State Total		1,037,519	

NORTH CAROLINA

CITY	COMPANY	AMOUNT ($'000)	BANK
Aberdeen	Carolina Galvanizing Corp.	27	IDB
Arden	Normac	436	IBRD/IDA
Cary	LeRoy Coggins	7	IDB
Chapel Hill	University of North Carolina	27	ADB
Charlotte	Coltex Export Corp.	160	IBRD/IDA
Charlotte	Dole Fresh Fruit Co.	658	IBRD/IDA
Charlotte	Henry Vogt Machine Co.	106	IBRD/IDA
Charlotte	Process Systems Inc.	267	IBRD/IDA
Charlotte	Process Systems Inc.	18	IDB
Charlotte	Styrotech Corp.	140	IBRD/IDA
Davidson	Ingersoll Rand Co.	308	IDB
Gastonia	Lithium Corp. of America	577	IBRD/IDA
Greensboro	Gilbarco Inc.	401	IBRD/IDA
Hickory	General Electric Co.	3,787	IDB
Mocksville	Ingersoll Rand Co.	29	IDB
New Bern	Johnson Machine Co.	31	IDB
Pinetops	ABB Power T&D Co.	81	IDB
Raleigh	Celanese Fibers Co.	217	IBRD/IDA
Raleigh	Meridith Jones Inc.	405	IBRD/IDA
Unspecified	John S. Adkin	41	IBRD/IDA
Unspecified	Mackay Communication USA	25	IBRD/IDA
Unspecified	Research Triangle Institute	283	IBRD/IDA

NORTH CAROLINA

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Robert Hornaday	9	IBRD/IDA
Unspecified	Undetermined	2,689	IBRD/IDA
State Total		10,729	

OHIO

CITY	COMPANY	AMOUNT ($'000)	BANK
Akron	Akron Standard	184	IBRD/IDA
Akron	Firestone Tire & Rubber	51	IDB
Akron	General Tire Int'l Co.	257	IBRD/IDA
Akron	Uniroyal Goodrich Tire Co.	209	IBRD/IDA
Amherst	Nordson Corp.	497	IBRD/IDA
Amherst	Nordson Corp.	277	IBRD/IDA
Bowling Green	Clarke Industries Inc.	83	IDB
Brewster	Wheeling & Lake Erie Railway	10	EBRD
Canton	Timken Co.	292	IBRD/IDA
Carey	Porcelain Products Co.	25	IDB
Cincinnati	Cincinnati Milacron Co.	1,356	IBRD/IDA
Cincinnati	Cogifer Inc.	417	IBRD/IDA
Cincinnati	Cogifer Inc.	204	IBRD/IDA
Cincinnati	Didier Taylor Refractories Co.	555	IBRD/IDA
Cincinnati	Quantum Chemicals Corp.	473	IBRD/IDA
Cincinnati	Proctor & Gamble	17,000	EBRD
Cleveland	Alcan Ingot	112	IBRD/IDA
Cleveland	Brodhead Garrett	507	IBRD/IDA
Cleveland	C.A. Litzler Co.	306	IBRD/IDA
Cleveland	DA Industries Sales Inc.	119	IBRD/IDA
Cleveland	Day-Glo Color Corp.	323	IBRD/IDA
Cleveland	Eveready Battery Co.	878	IBRD/IDA

OHIO

CITY	COMPANY	AMOUNT ($'000)	BANK
Cleveland	Goodyear Int'l	318	IBRD/IDA
Cleveland	Goodyear Tire and Rubber Co.	479	IBRD/IDA
Cleveland	Ohio Crankshaft Co.	237	IBRD/IDA
Cleveland	Plidco Int'l	479	ADB
Cleveland	Plidco Int'l	106	IBRD/IDA
Cleveland	Rosemount Inc.	16	IDB
Cleveland	Union Carbide Corp.	104	IBRD/IDA
Cleveland	White-Westinghouse Int'l Co.	116	AFDB
Columbus	Arthur Anderson & Co.	148	IBRD/IDA
Columbus	Eldred Int'l Export Corp.	275	IBRD/IDA
Columbus	Jemtec	1	IDB
Columbus	Libbey Owens - Lord Export Co.	113	IBRD/IDA
Chicago	Midwest Universities Consortium	11,284	IBRD/IDA
Columbus	Midwest Universities Consortium	6,783	IBRD/IDA
Columbus	Midwest Universities Consortium	6,000	ADF
Columbus	Midwest Universities Consortium	6,000	ADF
Chicago	Midwest Universities Consortium	3,343	IBRD/IDA
Columbus	Midwest Universities Consortium	1,272	IBRD/IDA
Columbus	Midwest Universities Consortium	866	IBRD/IDA
Columbus	Midwest Universities Consortium	500	ADF
Columbus	Midwest Universities Consortium	459	IBRD/IDA
Columbus	Midwest Universities Consortium	124	AFDB

OHIO

CITY	COMPANY	AMOUNT ($'000)	BANK
Columbus	Ohio State University	395	IBRD/IDA
Columbus	OI-NEG TV Products Inc.	1,417	IBRD/IDA
Coshocton	Ansell Edmont	1	IDB
Dayton	NCR Corp.	698	IBRD/IDA
Dayton	NCR Corp.	62	IBRD/IDA
Dayton	NCR Corp.	50	IBRD/IDA
Dayton	Ohio Electronic Engravers Inc.	469	IBRD/IDA
Dayton	Process Automation Business Inc.	1,046	IBRD/IDA
Dayton	Woolpert Consultants	15	IDB
Fostoria	Atlas Crankshaft Corp.	117	IBRD/IDA
Galion	Abillama Group	3,962	IBRD/IDA
Hudson	Terex Corp.	249	IBRD/IDA
Lancaster	Diamond Power	49	IDB
Lima	Sreco Flexible Int'l	2,874	IBRD/IDA
Lima	Sreco Flexible Int'l	1,867	IBRD/IDA
Lima	Sreco Flexible Int'l	1,077	IBRD/IDA
Lorain	Lorain Products	702	IBRD/IDA
Mansfield	Barnes Pumps Inc.	41	IDB
Mansfield	Garrett Brodhead	34	IBRD/IDA
Mansfield	Shafer Valve Co. Int'l	194	IBRD/IDA
Marietta	Forma Scientific Inc.	68	IDB
Marietta	Forma Scientific Inc.	37	IDB

OHIO

CITY	COMPANY	AMOUNT ($'000)	BANK
Mayfield Village	Preformed Line Products Co.	347	IBRD/IDA
Mentor	Caterpillar Industries Inc.	1,650	IBRD/IDA
Mount Vernon	Cooper Energy Services	639	IBRD/IDA
Mount Vernon	Energy Services Group	129	IBRD/IDA
Painesville	Fermenta Plant Protection	118	IBRD/IDA
Perrysburg	Glasstech Inc.	4,021	IBRD/IDA
Perrysburg	Glasstech Inc.	359	IBRD/IDA
Piqua	French Oil Mill Machinery Co.	1,786	IBRD/IDA
Piqua	French Oil Mill Machinery Co.	328	IBRD/IDA
Reynoldsburg	George W. Byrd	4	EBRD
Sidney	COP Int'l Inc.	494	IBRD/IDA
Sidney	Leroi - Dresser	145	IDB
Sidney	Leroi - Dresser	134	IDB
Sidney	Leroi - Dresser	46	IDB
Solon	Crawford Fitting Co.	15	IDB
Springfield	Cooper Industries	2,946	IBRD/IDA
Springfield	Dresser Industries Inc.	237	IBRD/IDA
Toledo	M/S Owens	2,007	ADB
Toledo	Owens-Illinois	43,100	EBRD
Toledo	Owens-Illinois	43,100	EBRD
Troy	Hobart Int'l	33	IDB
Unspecified	Bird Machine Co.	1,920	IBRD/IDA

OHIO

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Castlat Ltd	617	IBRD/IDA
Unspecified	Dyna Systems Inc.	288	IBRD/IDA
Unspecified	John H. Haberkern	77	IBRD/IDA
Unspecified	Reliance Electric Co.	127	IBRD/IDA
Unspecified	Steelastic Co.	1,011	AFDB
Unspecified	Undetermined	9,251	IBRD/IDA
Unspecified	Undetermined	1,103	ADB
Wadsworth	Ohio Brass Co.	2,069	IDB
Wadsworth	Ohio Brass Co.	122	IDB
Westerville	Hydro Group - Ranney Division	186	IBRD/IDA
Wickcliffe	Bailey Controls	1,583	IBRD/IDA
Wickcliffe	Bailey Controls	343	IBRD/IDA
Wickcliffe	Lubrizol Corp.	372	IBRD/IDA
Wickcliffe	Bailey Controls	7,219	IBRD/IDA
Willoughby	Cortest Inc.	326	ADB
State Total		206,834	

OKLAHOMA

CITY	COMPANY	AMOUNT ($'000)	BANK
Broken Arrow	Dresser Rand Sales Co.	1,362	IDB
Duncan	Halliburton Co.	2,027	IDB
Duncan	Halliburton Co.	1,956	IDB
Duncan	Halliburton Co.	1,013	IDB
Duncan	Halliburton Co.	36	IBRD/IDA
Duncan	Halliburton Environment Corp.	752	IBRD/IDA
Ochelata	Geomicrobial Technologies	140	IDB
Oklahoma City	Int'l Environmental	223	AFDB
Oklahoma City	K.F. Industries Inc.	2	ADB
Tulsa	Parker Drilling	4,209	IBRD/IDA
Tulsa	Sabre Int'l Inc.	262	ADB
Tulsa	Sabre Int'l Inc.	10	ADB
Tulsa	Sabre Int'l Inc.	8	ADB
Unspecified	Bethlehem Pipe	143	IBRD/IDA
Unspecified	Undetermined	3,043	IBRD/IDA
State Total		15,186	

OREGON

CITY	COMPANY	AMOUNT ($'000)	BANK
Beaverton	Tektronix Inc.	131	ADB
Beaverton	Textronix Inc.	43	IBRD/IDA
Beaverton	Undetermined	429	ADB
Eugene	China Technical Management Services	679	ADB
Hammond	Fishery Management Services	11	IIC
Medford	Oregon Woodchuck Inc.	19	IDB
Portland	CH2M Hill Int'l Corp.	112	IBRD/IDA
Portland	Oregon Software	8	IDB
Portland	Pacific Energy Associates	8	IDB
Portland	Sulzer Bingham	560	IBRD/IDA
Portland	Wagner Mining Equipment Co.	378	IBRD/IDA
Unspecified	Undetermined	985	IBRD/IDA
Unspecified	William K. Wood	32	IBRD/IDA
State Total		3,395	

PENNSYLVANIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Allentown	Mack Trucks Inc.	7,231	IBRD/IDA
Allentown	Mack Trucks Inc.	796	IBRD/IDA
Allentown	Mack Trucks Inc.	191	IDB
Allentown	Mack Trucks Inc.	182	IBRD/IDA
Ardmore	Elliot Davis	26	IDB
Bala Cynwyd	Purolite Group	19,500	EBRD
Bethlehem	Bethlehem Steel Exp. Corp.	1,019	IBRD/IDA
Bethlehem	Fuller Int'l Inc.	7,491	IBRD/IDA
Bethlehem	Fuller Int'l Inc.	6,391	IBRD/IDA
Bethlehem	Fuller Int'l Inc.	3,801	IBRD/IDA
Blairsville	Balco Inc.	810	IDB
Blue Bell	ABB Power T&D Co.	1,442	IDB
Blue Bell	ABB Power T&D Co.	382	IBRD/IDA
Blue Bell	Biddle Instruments	642	IDB
Chalfont	Ford Motor Co.	32	IDB
Concordville	Firemetal Products Co.	2	IDB
Coraopolis	Cooper Power Systems Inc.	1,906	IDB
Devon	Omara Inc.	137	IBRD/IDA
Dubois	Equimeter Inc.	1,570	ADB
Dubois	Equimeter Inc.	372	IBRD/IDA
Dubois	Equimeter Inc.	215	ADB
Dubois	Equimeter Inc.	167	ADB

PENNSYLVANIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Dubois	Equimeter Inc.	153	ADB
Erie	General Electric Co.	11,341	IBRD/IDA
Erie	General Electric Co.	2,006	IBRD/IDA
Erie	General Electric Co.	707	IBRD/IDA
Erie	General Electric Co.	683	IBRD/IDA
Erie	General Electric Co.	210	IBRD/IDA
Erie	General Electric Co.	120	IBRD/IDA
Erie	General Electric Co.	94	IBRD/IDA
Erie	General Electric Co.	4	IBRD/IDA
Erie	Knox-Western	347	IBRD/IDA
Fort Washington	Pilling	59	IDB
Greenville	R.D. Werner Co.	167	ADB
Harrisburg	Leeds & Northrup	1,078	IBRD/IDA
Harrisburg	Leeds & Northrup	896	IBRD/IDA
Hatboro	Air Shields Vickers	238	IDB
Hatboro	Air Shields Vickers	20	IDB
Horsham	American Meter Co.	167	ADB
Lockhaven	General Aviation Technical Services	2,439	IIC
Monroeville	Pennsylvania State University	32	IDB
Monroeville	Thermal Transfer Corp.	391	AFDB
Nazareth	Idea Inc.	112	IBRD/IDA
New Holland	Ford New Holland Inc.	254	IBRD/IDA

PENNSYLVANIA

CITY	COMPANY	AMOUNT ($'000)	BANK
New Holland	Ford New Holland Inc.	24	IDB
Palmyra	Philadelphia Mixers	1,053	IBRD/IDA
Philadelphia	American Meter Co.	289	IBRD/IDA
Philadelphia	Arco Chemical Co.	126	IBRD/IDA
Philadelphia	Bell Atlantic	2,000	EBRD
Philadelphia	Boekel Industries Inc.	2	IDB
Philadelphia	Ford Motor Co.	1,817	IBRD/IDA
Philadelphia	Ford Motor Co.	1,748	IBRD/IDA
Philadelphia	Ford Motor Co.	1,500	IBRD/IDA
Philadelphia	Ford Motor Co.	326	IBRD/IDA
Philadelphia	Ford Motor Co. - Marine	307	IBRD/IDA
Philadelphia	IBM World Trade Corp.	245	IBRD/IDA
Philadelphia	Int'l Raw Material	171	IBRD/IDA
Philadelphia	John J. Terry	25	EBRD
Philadelphia	Kuljian Corp.	92	AFDB
Philadelphia	Mack Trucks Inc.	1,195	IBRD/IDA
Philadelphia	MS Corp. Op.	231	IBRD/IDA
Philadelphia	NAO Inc.	56	IBRD/IDA
Philadelphia	Paper Corp.	159	IBRD/IDA
Philadelphia	Paul Rizzo Associates	405	IBRD/IDA
Philadelphia	Philips Components	158	IBRD/IDA
Philadelphia	Philips Lighting	109	IBRD/IDA

PENNSYLVANIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Philadelphia	Pryor, McClendon, Counts & Co.	5,000	IFC
Philadelphia	Pryor, McClendon, Counts & Co.	545	IFC
Philadelphia	Silberline Mfg. Co.	1,041	IBRD/IDA
Philadelphia	Univ. of Pennsylvania - Wharton School	200	EBRD
Pittsburgh	ABB Power T&D Co.	3,904	IDB
Pittsburgh	ABB Power T&D Co.	390	IBRD/IDA
Pittsburgh	ABB Power T&D Co.	87	IBRD/IDA
Pittsburgh	ABB Power T&D Co.	53	IDB
Pittsburgh	AEG Westinghouse	2,124	IBRD/IDA
Pittsburgh	AEG Westinghouse	571	IBRD/IDA
Pittsburgh	AEG Westinghouse	296	IBRD/IDA
Pittsburgh	Allied Capital Corp.	4,000	IFC
Pittsburgh	Cooper Power Systems Inc.	6,590	IBRD/IDA
Pittsburgh	Cooper Power Systems Inc.	1,533	IBRD/IDA
Pittsburgh	Cooper Power Systems Inc.	1,254	ADB
Pittsburgh	Cooper Power Systems Inc.	868	IBRD/IDA
Pittsburgh	Cooper Power Systems Inc.	257	IBRD/IDA
Pittsburgh	Cooper Power Systems Inc.	64	IBRD/IDA
Pittsburgh	Cooper Power Systems Inc.	6	IBRD/IDA
Pittsburgh	ICF Kaiser Engineers Inc.	139	ADB
Pittsburgh	Int'l Water Corp.	133	IBRD/IDA
Pittsburgh	John T. Boyd Co.	579	IBRD/IDA

PENNSYLVANIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Pittsburgh	John T. Boyd Co.	114	'BRD/IDA
Pittsburgh	John T. Boyd Co.	8	IBRD/IDA
Pittsburgh	Koppers Co.	2,650	IBRD/IDA
Pittsburgh	Koppers Co.	224	IBRD/IDA
Pittsburgh	McGraw Edison	161	IBRD/IDA
Pittsburgh	McGraw Edison	28	IDB
Pittsburgh	Pinter Co.	433	IBRD/IDA
Pittsburgh	PPG Industries Inc.	4,862	IBRD/IDA
Pittsburgh	Union Switch & Signals	1,531	IBRD/IDA
Pittsburgh	University of Pittsburgh	15	AFDB
Pittsburgh	Videcon Int'l	174	IBRD/IDA
Pittsburgh	Westinghouse	488	IBRD/IDA
Pittsburgh	Westinghouse Products Int'l Inc.	1,764	AFDB
Pittsburgh	Westinghouse Products Int'l Inc.	1,529	IBRD/IDA
Pittsburgh	Wheelabrator Air Pollution Control	5,320	IBRD/IDA
Pittsburgh	Wheelabrator Air Pollution Control	348	IBRD/IDA
Pittsburgh	White Westinghouse Int'l	585	IBRD/IDA
Pottstown	Neapco Inc.	128	IBRD/IDA
Reading	Gilbert Commonwealth Int'l	7,401	IBRD/IDA
Reading	Gilbert Commonwealth Int'l	1,592	IBRD/IDA
Reading	Gilbert Commonwealth Int'l	276	IBRD/IDA
Reading	Mercator Corp.	135	IBRD/IDA

PENNSYLVANIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Reading	Mercator Corp.	131	IBRD/IDA
Richboro	G. Kolesar & Associates	100	IDB
Richboro	G. Kolesar & Associates	100	IDB
Scranton	Acker Drill Co.	500	IBRD/IDA
Sewickley	Vanness Co.	400	IDB
Sewickley	Vanness Co.	200	IDB
Sewickley	Vanness Co.	200	IDB
Sewickley	Vanness Co.	189	IBRD/IDA
Shady Grove	Grove North America	584	IDB
Stroudsburg	General Electric Co.	1,000	IBRD/IDA
Stroudsburg	General Electric Co.	462	IBRD/IDA
Stroudsburg	General Electric Co.	210	IBRD/IDA
Stroudsburg	General Electric Co.	120	IBRD/IDA
Tobyhanna	Weroshen Int'l	26	IDB
Unspecified	Britton Harris	22	IBRD/IDA
Unspecified	Gannett Fleming	191	IBRD/IDA
Unspecified	Gannett Fleming	162	IBRD/IDA
Unspecified	Gannett Fleming	976	IBRD/IDA
Unspecified	General Refractories Co.	272	IBRD/IDA
Unspecified	Undetermined	7,200	IBRD/IDA
Unspecified	Undetermined	488	ADB
Valley Forge	Compton & Associates Inc.	9	IIC

PENNSYLVANIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Waukesha	Svedala Industries	223	IBRD/IDA
Waynesboro	Litton Industrial Automation System	2,616	IBRD/IDA
Waynesboro	Litton Industrial Automation System	959	IBRD/IDA
Willow Grove	Tinius Inc.	94	IDB
Wilmerding	Westinghouse - Airbrake Division	224	IBRD/IDA
York	Mineral Processing Systems Inc.	4,374	IBRD/IDA
York	Mineral Processing Systems Inc.	538	IBRD/IDA
York	Svedala Industries	5,167	IBRD/IDA
York	Svedala Industries	675	IBRD/IDA
State Total		175,673	

PUERTO RICO

CITY	COMPANY	AMOUNT ($'000)	BANK
Carolina	Bioanalytical Instruments	66	IDB
Hato Rey	ABB Power T&D Co.	84	IDB
Isabela	ABB Kent Meters Inc.	2,473	IDB
Rio Pedras	Caribe General Electric Co.	86	IDB
San Juan	ABB Power T&D Co.	61	IDB
San Juan	Caribe General Electric Co.	196	IDB
San Juan	Caribe General Electric Products Inc.	1,416	IDB
San Juan	Clapp & Mayne Inc.	642	IDB
San Juan	Clapp & Mayne Inc.	456	IDB
San Juan	Clapp & Mayne Inc.	186	IDB
San Juan	Motorambar	198	IDB
Unspecified	Prosecar Co. Ltd	159	IBRD/IDA
Unspecified	Undetermined	356	IBRD/IDA
State Total		6,379	

RHODE ISLAND

CITY	COMPANY	AMOUNT ($'000)	BANK
Cranston	Muller Co.	384	IDB
Narragansett	University of Rhode Island - Coast Research Ctr.	25	IDB
Newport	EPLAB	9	IDB
Unspecified	Undetermined	4,134	IBRD/IDA
West Kingston	Smart Inc.	12	IDB
State Total		4,564	

SOUTH CAROLINA

CITY	COMPANY	AMOUNT ($'000)	BANK
Columbia	Research Planning Inc.	85	IDB
Columbia	Research Planning Inc.	85	IDB
Columbia	Wilbur Smith Associates	2,308	IBRD/IDA
Columbia	Wilbur Smith Associates	1,602	IBRD/IDA
Columbia	Wilbur Smith Associates	1,196	ADB
Columbia	Wilbur Smith Associates	1,157	IBRD/IDA
Columbia	Wilbur Smith Associates	1,007	IBRD/IDA
Columbia	Wilbur Smith Associates	916	IBRD/IDA
Columbia	Wilbur Smith Associates	721	IBRD/IDA
Columbia	Wilbur Smith Associates	698	ADB
Columbia	Wilbur Smith Associates	698	ADB
Columbia	Wilbur Smith Associates	591	ADB
Columbia	Wilbur Smith Associates	263	IBRD/IDA
Columbia	Wilbur Smith Associates	196	IBRD/IDA
Florence	L-Tec Welding & Cutting Systems	536	IBRD/IDA
Fort Lawn	Morrison Textile Machinery Co.	2,356	IBRD/IDA
Fort Lawn	Morrison Textile Machinery Co.	58	IBRD/IDA
Gilbert	Avtec Inc.	188	IBRD/IDA
Greenville	Michelin Tire Corp.	38	IDB
Mount Holly	J.W. Aluminum	527	IBRD/IDA
Unspecified	Intrade Intercontinental Inc.	160	IBRD/IDA
Unspecified	Undetermined	1,712	IBRD/IDA

SOUTH CAROLINA

CITY	COMPANY	AMOUNT ($'000)	BANK
West Columbia	Tamper Corp.	1,636	IBRD/IDA
State Total		18,734	

TENNESSEE

CITY	COMPANY	AMOUNT ($'000)	BANK
Memphis	All American Cotton Co.	1,821	IBRD/IDA
Memphis	All American Cotton Co.	159	IBRD/IDA
Memphis	Allenberg Cotton Co.	532	IBRD/IDA
Memphis	Arcadian Corp.	33,724	MIGA
Memphis	Arcadian Corp.	12,127	MIGA
Memphis	Arcadian Corp.	2,074	MIGA
Memphis	Arcadian Corp.	2,074	MIGA
Memphis	Dunavant Enterprises	800	IBRD/IDA
Memphis	Eastman Chemical Int'l Co.	8,554	IBRD/IDA
Memphis	George McFadden & Brothers Inc.	155	IBRD/IDA
Memphis	Hohenberg Brothers Co.	414	IBRD/IDA
Memphis	Hohenberg Brothers Co.	404	IBRD/IDA
Memphis	Int'l Paper Co.	277	IBRD/IDA
Memphis	Proctor & Gamble	256	IBRD/IDA
Rogersville	TRW Steering	568	IBRD/IDA
Unspecified	C.S. Services Ltd	405	IBRD/IDA
Unspecified	Undetermined	724	IBRD/IDA
State Total		65,068	

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Austin	Austin Computer System	4	IDB
Austin	Dell Corp.	42	IDB
Austin	Houston Instruments	14	IDB
Austin	Millennium Computing Group	31	EBRD
Austin	Radian Corp.	225	IBRD/IDA
Beaumont	IRI Int'l Corp.	2,493	IBRD/IDA
Beaumont	IRI Int'l Corp.	7	IBRD/IDA
Brookshire	Johnston Pump Co.	624	IBRD/IDA
Brookshire	Johnston Pump Co.	471	IBRD/IDA
Brownsville	Texas & Frontier Machinery	4,180	IBRD/IDA
Carrollton	Core Labs	238	IBRD/IDA
College Station	G. Truman Fincher	9	IDB
Conroe	Murex Biological Inc.	12	IDB
Conroe	Cliff Mock Co.	9	ADB
Dallas	Commercial Metals Co.	709	IBRD/IDA
Dallas	Core Labs	996	IBRD/IDA
Dallas	Core Labs	729	IBRD/IDA
Dallas	Core Labs	334	IBRD/IDA
Dallas	Dresser Industries Inc.	263	IBRD/IDA
Dallas	Dresser Industries Inc.	168	ADB
Dallas	Dual Marine Co.	4,426	IBRD/IDA
Dallas	Ensco Tool & Supply Co.	386	IBRD/IDA

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Dallas	Gaffney, Cline & Associates	716	IBRD/IDA
Dallas	Geological Supply Co.	153	IBRD/IDA
Dallas	Graham Magnetics Inc.	220	IBRD/IDA
Dallas	Lennox Industries Inc.	40	IDB
Dallas	Messina Co.	512	IBRD/IDA
Dallas	Messina Co.	252	IBRD/IDA
Dallas	M. W. Kellogg Co.	446	IBRD/IDA
Dallas	Occidental Chemical Corp.	1,955	IBRD/IDA
Dallas	Otis Engineering	899	IBRD/IDA
Dallas	Republic Supply Co.	3,973	IBRD/IDA
Dallas	Smith Int'l Inc.	1,410	IBRD/IDA
Dallas	Smith Int'l Inc.	114	IBRD/IDA
Dallas	Varel Manufacturing Co.	908	IBRD/IDA
Dallas	Wallace O'Connor	3,674	IBRD/IDA
Dallas	Wallace O'Connor	6,369	IBRD/IDA
Dallas	Wallace O'Connor	6,202	IBRD/IDA
El Paso	Export Sleyzan	299	IBRD/IDA
El Paso	Potrans Consultants	17	IIC
Fort Worth	Gearhart Industries	263	IBRD/IDA
Fort Worth	Halliburton Logging Services	9,077	IBRD/IDA
Fort Worth	Halliburton Logging Services	8,271	IBRD/IDA
Fort Worth	Halliburton Logging Services	72	ADB

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Fort Worth	Hydra Rig Inc.	7,000	EBRD
Fort Worth	Hydra Rig Inc.	2,677	IBRD/IDA
Fort Worth	Hydra Rig Inc.	1,093	IBRD/IDA
Fort Worth	Hydra Rig Inc.	549	ADB
Fort Worth	Owen Oil Tools Inc.	117	ADB
Fort Worth	Owen Oil Tools Inc.	34	ADB
Freeport	Brazos Pipe & Steel Fabricator	555	IBRD/IDA
Houston	AC Compressor Corp.	326	IBRD/IDA
Houston	ACM Export Corp.	76	IDB
Houston	Agrtol Chemical Products	259	IBRD/IDA
Houston	Agrtol Chemical Products	140	IBRD/IDA
Houston	American Agents Inc.	972	IDB
Houston	American Energy Services	43	ADB
Houston	American Gulf Co.	47	IDB
Houston	American Gulf Co.	4	IDB
Houston	Atlas Industrial Supply Inc.	1,213	IBRD/IDA
Houston	Baker Oil Tools	2,536	IBRD/IDA
Houston	Baker Oil Tools	314	IBRD/IDA
Houston	Baker Oil Tools	116	ADB
Houston	Baker Oil Tools	108	IBRD/IDA
Houston	Baker Oil Tools	58	ADB
Houston	Bardid Drilling Fluids	187	IBRD/IDA

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Houston	Big Three Int'l - Bowen Division	1,163	IBRD/IDA
Houston	Bonner & Moore Assoc. Inc.	243	IBRD/IDA
Houston	Boyce Engineering Int'l	172	IBRD/IDA
Houston	BWIP Pump Int'l Inc.	1,666	IBRD/IDA
Houston	BWIP Pump Int'l Inc.	233	IBRD/IDA
Houston	Cameron Iron Works Inc.	2,487	IBRD/IDA
Houston	Carrier Interamericas	233	IBRD/IDA
Houston	Cherco Compressors Inc.	714	IBRD/IDA
Houston	Chibb National	155	IBRD/IDA
Houston	Combustion Engineering Inc.	6,320	IBRD/IDA
Houston	Compac Computer Corp.	387	IBRD/IDA
Houston	Conoco Inc.	90,000	EBRD
Houston	Conoco Inc.	1,070	IBRD/IDA
Houston	Continent Emsco	1,279	IBRD/IDA
Houston	Continental Laboratories	279	IDB
Houston	Copper & Brass Int'l	159	IBRD/IDA
Houston	Core Labs	937	IBRD/IDA
Houston	Core Labs	294	IBRD/IDA
Houston	Curtin Matheson	65	IDB
Houston	Daniel Industries Inc.	41	ADB
Houston	Davis Lynch Inc.	3	ADB
Houston	DI Int'l Inc.	6,089	IDB

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Houston	Digicon Geophysical Corp.	7,546	IDB
Houston	Dole Fresh Fruit Co.	449	IBRD/IDA
Houston	Dow Chemical Int'l Inc.	255	IBRD/IDA
Houston	Dowelanco	440	IBRD/IDA
Houston	Dresser Industries Inc.	370	ADB
Houston	Dresser Rand Sales Co.	4,046	IBRD/IDA
Houston	Eastman Christensen	178	IBRD/IDA
Houston	Elliott Co.	103	IBRD/IDA
Houston	Emba Corp.	170	IBRD/IDA
Houston	ENRON	9,650	EBRD
Houston	Ensco Tool & Supply Co.	140	IBRD/IDA
Houston	Essex Enterprises Inc.	1,101	IBRD/IDA
Houston	Exxon Chemical Trading Inc.	6,047	IBRD/IDA
Houston	Exxon Co. USA Corp.	104	IBRD/IDA
Houston	Fish Int'l Engineers	269	IBRD/IDA
Houston	Fish Int'l Engineers	117	IBRD/IDA
Houston	Fisher Industries	490	IBRD/IDA
Houston	Foster Valve Corp.	1,823	IDB
Houston	Foxboro Co.	224	IBRD/IDA
Houston	Gaffney, Cline & Associates	83	IBRD/IDA
Houston	General Affiliates Corp.	3,579	IBRD/IDA
Houston	General Electric Co.	311	IBRD/IDA

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Houston	Griffin Int'l Corp.	509	IBRD/IDA
Houston	Grum Inc. Chemicals	4,826	IBRD/IDA
Houston	Gulf Pacific Rice Co.	528	IBRD/IDA
Houston	Gundle Lining Systems Inc.	311	IIC
Houston	Halliburton Co.	5,549	IBRD/IDA
Houston	Halliburton Co.	242	IBRD/IDA
Houston	Halliburton Logging Services	2,161	IBRD/IDA
Houston	Harrisburg Inc.	7	ADB
Houston	Hatch & Kirk Inc.	131	IDB
Houston	HCI Chemicals Overseas	249	IBRD/IDA
Houston	Hilmar Zeissig	18	IDB
Houston	Hilmar Zeissig	13	IDB
Houston	Honeywell Inc.	163	IBRD/IDA
Houston	Hughes Tool Ltd	597	IBRD/IDA
Houston	ICI Americas	187	IBRD/IDA
Houston	Imo Deleval Inc.	201	IBRD/IDA
Houston	Interkiln Corp. of America	2,663	AFDB
Houston	IRI Int'l Corp.	16,854	IBRD/IDA
Houston	IRI Int'l Corp.	1,090	IBRD/IDA
Houston	IRI Int'l Corp.	1,002	IBRD/IDA
Houston	IRI Int'l Corp.	33	ADB
Houston	IRI Int'l Corp.	5	ADB

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Houston	James B. Smith	219	ADB
Houston	Kanematsu U.S.A. Inc.	1,304	IBRD/IDA
Houston	Kanematsu U.S.A. Inc.	1,260	IBRD/IDA
Houston	Kellogg Overseas Corp.	44,164	IBRD/IDA
Houston	Kellogg Overseas Corp.	17,347	IBRD/IDA
Houston	Kellogg Overseas Corp.	1,765	IBRD/IDA
Houston	Kellogg Overseas Corp.	1,033	IBRD/IDA
Houston	Lawrence Export Service	248	IBRD/IDA
Houston	Lithcon Petroleum USA Inc.	2,117	IBRD/IDA
Houston	Mark Products	730	IBRD/IDA
Houston	Masoneilan Dresser	326	IBRD/IDA
Houston	McKenzie Equipment Co.	375	IBRD/IDA
Houston	Metrix Instrument Co.	203	IBRD/IDA
Houston	Minnesota Valley Engineering	496	IBRD/IDA
Houston	Mitsui Plastics Inc.	280	IBRD/IDA
Houston	Mitsui & Co.	7,786	IBRD/IDA
Houston	Murata Business Systems	138	IBRD/IDA
Houston	M. W. Kellogg Co.	2,230	IBRD/IDA
Houston	Nabors Industries Inc.	14,560	IDB
Houston	Nabors Industries Inc.	479	IDB
Houston	Nabors Industries Inc.	60	IDB
Houston	Nabors Industries Inc.	45	IDB

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Houston	National Oilwell	2,209	IBRD/IDA
Houston	National Oilwell	1,117	IBRD/IDA
Houston	National Oilwell	524	IBRD/IDA
Houston	National Strand Products	1,941	IBRD/IDA
Houston	National Strand Products	1,852	IBRD/IDA
Houston	N.L. Shaffer Industries Inc.	3,067	IBRD/IDA
Houston	Oil & Gas Specialist	105	ADB
Houston	Oilworld Supply Co.	498	IBRD/IDA
Houston	Omsco Industries	1,088	IBRD/IDA
Houston	Pecten Chemicals Inc.	1,229	IBRD/IDA
Houston	Pecten Chemicals Inc.	349	IBRD/IDA
Houston	Permargo Int'l Corp.	12,208	IBRD/IDA
Houston	Permargo Int'l Corp.	195	IBRD/IDA
Houston	Perry Equipment Corp.	353	IBRD/IDA
Houston	Perry Equipment Corp.	206	IBRD/IDA
Houston	Reed Tool Co.	124	ADB
Houston	Regal Int'l Inc.	209	IBRD/IDA
Houston	Ross Hill Controls Corp.	717	IBRD/IDA
Houston	Rowan Inc.	2,704	IBRD/IDA
Houston	Ryder Scott Co.	9	EBRD
Houston	Saavco Int'l	211	IBRD/IDA
Houston	Shafer Valve Co.	239	IBRD/IDA

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Houston	Shafer Valve Co.	83	'BRD/IDA
Houston	Shell Oil Co.	2,300	IBRD/IDA
Houston	Smith Int'l Inc.	155	ADB
Houston	Smith Tool Co.	129	IBRD/IDA
Houston	Soconordorf	1,152	ADB
Houston	Sonat Offshore Drilling Inc.	23,004	IBRD/IDA
Houston	Special Industries Inc.	5,839	IBRD/IDA
Houston	Special Industries Inc.	3,600	EBRD
Houston	Special Industries Inc.	528	IBRD/IDA
Houston	Stewart Stevenson Service	1,327	IBRD/IDA
Houston	Stewart Stevenson Service	1,125	IBRD/IDA
Houston	Tamsa Inc.	164	IBRD/IDA
Houston	Tapco Int'l	206	IBRD/IDA
Houston	Tapco Int'l	132	IBRD/IDA
Houston	Tapco Int'l	15	IBRD/IDA
Houston	Techmation Inc.	1,526	IBRD/IDA
Houston	Techmation Inc.	150	IBRD/IDA
Houston	Technology Export Co.	447	IBRD/IDA
Houston	Tomen America Inc.	1,415	IBRD/IDA
Houston	Transmarketing	7,500	IBRD/IDA
Houston	Tubacero S. A.	841	IBRD/IDA
Houston	Union Carbide Chemical & Plastic	175	IBRD/IDA

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Houston	Union Carbide Interamerica	2,775	IBRD/IDA
Houston	University of Houston	182	EBRD
Houston	Valmet Automation	2,383	IDB
Houston	Vertek Industrial Supply	802	IDB
Houston	Vinmar Inc.	5,952	IBRD/IDA
Houston	Vinson Supply Co.	1,196	IBRD/IDA
Houston	Vista Chemical Co.	205	IBRD/IDA
Houston	Walter Matter, S. A.	1,447	IBRD/IDA
Houston	Walworth Co.	359	IBRD/IDA
Houston	Wargo	167	IBRD/IDA
Houston	Western Atlas	1,359	IBRD/IDA
Houston	Western Co. of North America	3,171	IBRD/IDA
Houston	Western Geophysical Co.	316	IBRD/IDA
Houston	Westinghouse Electric Co.	714	IBRD/IDA
Houston	Woolley Tool & Mfg. Inc.	179	IBRD/IDA
Irving	Greiner Inc.	5,926	IDB
Kingwood	Barbara Evans	8	EBRD
Laredo	Photonic Inc.	405	IBRD/IDA
Laredo	Ramsco	502	IDB
Le Marque	Tri-Sen Systems	695	IDB
Lockney	Tye Co.	104	IDB
Longview	Marathon Le Tourneau Co.	2,080	AFDB

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Lubbock	Plains Cotton Coop. Assoc.	2,203	IBRD/IDA
Lubbock	Texas Cotton Trading Co.	122	IBRD/IDA
Mansfield	Try-Flow Systems	94	IDB
Mineral Wells	Perry Equipment Corp.	444	ADB
Mineral Wells	Perry Equipment Corp.	92	ADB
North Marble Hills	D.C. Oil Tools	232	IBRD/IDA
Odessa	Claude Boyd	16	IDB
Oklahoma City	Swaco Geolograph Co.	518	IBRD/IDA
Richardson	Phillips Drisco Pipe	215	IBRD/IDA
Rosharon	Schlumberger	315	IBRD/IDA
Round Rock	Westinghouse Motor	291	IDB
San Antonio	Newell Enterprises	668	IBRD/IDA
South Lake	Memo Int'l Inc.	1,542	IBRD/IDA
Spring	Carbide Blast Joints	901	ADB
Sugarland	BGM Airborne Survey Inc.	623	IBRD/IDA
Sugarland	BGM Airborne Survey Inc.	267	IBRD/IDA
Sugarland	Bio-Rad	53	IDB
Sulphur Springs	Nordstrom Valves Inc.	832	IBRD/IDA
Sulphur Springs	Nordstrom Valves Inc.	183	ADB
Sulphur Springs	Nordstrom Valves Inc.	3	ADB
Temple	Artco-Bell Corp.	556	IBRD/IDA
Temple	Artco-Bell Corp.	197	IBRD/IDA

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Temple	Vittetoe, Bishay & Assoc. Inc.	300	IDB
Tenneco	Packaging Corp. of America	7,000	EBRD
The Woodlands	Hughes Christensen	491	IBRD/IDA
Unspecified	Avanti Consulting Inc.	755	IBRD/IDA
Unspecified	Baroid Sales Export Corp.	699	IDB
Unspecified	British American Scientific	323	IBRD/IDA
Unspecified	Brown Fintube Co.	30	IBRD/IDA
Unspecified	Elect Meca De Mexico	261	IBRD/IDA
Unspecified	Erisa Export Inc.	712	IBRD/IDA
Unspecified	First Gulf Int'l Inc.	189	IBRD/IDA
Unspecified	Greater Caribbean Energy & Environment	38	IBRD/IDA
Unspecified	Halliburton Co.	2,161	IBRD/IDA
Unspecified	Hitesi Products Inc.	9	IBRD/IDA
Unspecified	Lab-Volt Systems	129	IBRD/IDA
Unspecified	Lab-Volt Systems	85	IBRD/IDA
Unspecified	Landmark Graphics Corp.	3,045	IBRD/IDA
Unspecified	Landmark Graphics Corp.	3,045	IBRD/IDA
Unspecified	LTV	276	IBRD/IDA
Unspecified	Paragon Engineering Services Inc.	25,958	IBRD/IDA
Unspecified	Paragon Engineering Services Inc.	138	IBRD/IDA
Unspecified	Robert Boris Gaul	42	IBRD/IDA
Unspecified	Rodney Smith	98	IBRD/IDA

TEXAS

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Sargent Industries	142	IBRD/IDA
Unspecified	Stone & Webster Int'l	125	IBRD/IDA
Unspecified	Texas Energy	92	IBRD/IDA
Unspecified	Thomas D. Murray	1	IBRD/IDA
Unspecified	Trate Inc.	11	IBRD/IDA
Unspecified	Undetermined	5,683	ADB
Unspecified	Union Pump Co.	41	IBRD/IDA
Unspecified	University of Texas	17	ADF
Victoria	Elder Oil Tools	110	IBRD/IDA
Victoria	Energy Industries	1,075	IBRD/IDA
Waco	Time Manufacturing Co.	4,587	IDB
Waco	Time Manufacturing Co.	2,683	IBRD/IDA
Woodland	Dow Geochemical Service Inc.	205	IDB
State Total		551,441	

UTAH

CITY	COMPANY	AMOUNT ($'000)	BANK
Provo	Brigham Young University	120	ADF
Salt Lake City	Christopher Shugart	15	EBRD
Salt Lake City	Einco Process Equipment Co.	172	IBRD/IDA
Salt Lake City	Northwest Mine Services Inc.	384	IBRD/IDA
Salt Lake City	Northwest Mine Services Inc.	284	IBRD/IDA
Salt Lake City	Northwest Mine Services Inc.	13	IBRD/IDA
Salt Lake City	Robert & Schaefer Co.	148	EBRD
Unspecified	Undetermined	505	IBRD/IDA
State Total		1,641	

VERMONT

CITY	COMPANY	AMOUNT ($'000)	BANK
Burlington	Associates in Rural Development Inc.	282	IBRD/IDA
Burlington	Associates in Rural Development Inc.	227	IDB
Burlington	Associates in Rural Development Inc.	100	IBRD/IDA
Burlington	Scott-European Corp.	866	IBRD/IDA
Burlington	Scott-European Corp.	361	IBRD/IDA
Unspecified	John Heermans	128	IBRD/IDA
Unspecified	John Heermans	107	IBRD/IDA
Unspecified	Undetermined	3	IBRD/IDA
State Total		2,074	

VIRGINIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Alexandria	A.T. Kearney Inc.	120	EBRD
Alexandria	Emily L. Walker	6	EBRD
Alexandria	Emily L. Walker	1	EBRD
Alexandria	Thunder & Associates Inc.	172	AFDB
Annandale	Clarence Zuvekas, Jr.	2	IDB
Arlington	Aries Group	770	ADB
Arlington	A.T.A. Associates Ltd	632	IBRD/IDA
Arlington	A.T.A. Associates Ltd	270	IBRD/IDA
Arlington	Business & Government Strategies Int'l	100	ADB
Arlington	Carana Corp.	70	IDB
Arlington	Carana Corp.	60	IDB
Arlington	Carana Corp.	3	IDB
Arlington	Development Ideas Inc.	58	IDB
Arlington	Development Ideas Inc.	19	IDB
Arlington	Development Ideas Inc.	16	IDB
Arlington	Development Ideas Inc.	6	IDB
Arlington	First Washington Associates	26	EBRD
Arlington	First Washington Associates	12	IBRD/IDA
Arlington	ICI Corp.	98	IDB
Arlington	Industrial & Commerce Int'l	118	IDB
Arlington	Institutional Development Association	37	IDB
Arlington	Inter-American Management Consulting Group	113	IDB

VIRGINIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Arlington	Inter-American Management Consulting Group	75	IDB
Arlington	Inter-American Management Consulting Group	9	IDB
Arlington	John Bursink	9	IBRD/IDA
Arlington	Jose Dominguez	49	IDB
Arlington	J.E. Austin Associates Inc.	31	IDB
Arlington	J.E. Austin Associates Inc.	30	IDB
Arlington	J.E. Austin Associates Inc.	27	IDB
Arlington	J.E. Austin Associates Inc.	11	IDB
Arlington	J.E. Austin Associates Inc.	11	IDB
Arlington	L.T. Associates Inc.	20	AFDB
Arlington	Magnox Inc.	226	IBRD/IDA
Arlington	Nathan Associates Inc.	121	IBRD/IDA
Arlington	Nathan Associates Inc.	73	IDB
Arlington	Nathan Associates Inc.	17	IBRD/IDA
Arlington	Nathan Associates Inc.	14	IDB
Arlington	Nature Conservancy	10	IDB
Arlington	Nature Conservancy	5	IDB
Arlington	Optima Technical Services	528	IDB
Arlington	Optima Technical Services	53	IDB
Arlington	Optima Technical Services	18	IDB
Arlington	Optima Technical Services	18	IDB
Arlington	Optima Technical Services	18	IDB

VIRGINIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Arlington	Optima Technical Services	18	IDB
Arlington	Optima Technical Services	10	IDB
Arlington	RCG Hagler Bailly Inc.	210	IDB
Arlington	RCG Hagler Bailly Inc.	125	IBRD/IDA
Arlington	RCG Hagler Bailly Inc.	62	EBRD
Arlington	Services Group Inc.	150	IBRD/IDA
Arlington	Services Group Inc.	85	IBRD/IDA
Arlington	Services Group Inc.	47	IBRD/IDA
Arlington	Services Group Inc.	21	IDB
Arlington	Volunteers in Technical Assistance	856	IBRD/IDA
Arlington	Volunteers in Technical Assistance	606	IBRD/IDA
Arlington	Volunteers in Technical Assistance	339	IBRD/IDA
Arlington	Volunteers in Technical Assistance	272	IBRD/IDA
Arlington	Volunteers in Technical Assistance	116	IBRD/IDA
Ashburn	Int'l Business & Technical Cons. Inc.	562	IBRD/IDA
Ashburn	Int'l Business & Technical Cons. Inc.	490	IBRD/IDA
Burke	Charles Dollar	2	EBRD
Christiansburg	Hubbell Inc.	844	IDB
Christiansburg	Hubbell-Lighting Division	913	IDB
Christiansburg	Hubbell-Lighting Division	749	IDB
Fairfax	Airways Engineering Associates	4,321	ADF
Fairfax	EEC Inc.	25	IDB

VIRGINIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Fairfax	ICF Int'l	307	IBRD/IDA
Fairfax	ICF Int'l	211	IBRD/IDA
Falls Church	Transcomm Inc.	168	IBRD/IDA
Herndon	Post Buckley Int'l Inc.	2,041	AFDB
Lynchburg	Alliance Industrial Corp.	146	IBRD/IDA
Lynchburg	Ericsson GE Mobile Comm.	222	IDB
McLean	Booz, Allen & Hamilton Inc.	369	IBRD/IDA
McLean	Booz, Allen & Hamilton Inc.	316	EBRD
McLean	Booz, Allen & Hamilton Inc.	167	IBRD/IDA
McLean	Institute for Int'l Research	291	IBRD/IDA
McLean	Institute for Int'l Research	115	IBRD/IDA
McLean	Institute for Int'l Research	60	IBRD/IDA
McLean	Otto Raggambi	47	EBRD
McLean	Public Administration Services	349	IBRD/IDA
McLean	Public Administration Services	244	IBRD/IDA
McLean	Public Administration Services	147	IBRD/IDA
McLean	Public Administration Services	131	IBRD/IDA
McLean	Public Administration Services	93	AFDB
McLean	Public Administration Services	59	IBRD/IDA
McLean	Science Applications Int'l	63	EBRD
McLean	Sparks Commodities Inc.	93	IDB
McLean	William Smith	17	EBRD

VIRGINIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Norfolk	Chilean Nitrate Corp.	181	IBRD/IDA
Norfolk	Peck Recycling Co.	1,449	IBRD/IDA
Reston	Sprint Int'l Communication Corp.	12,971	IBRD/IDA
Reston	Sprint Int'l Communication Corp.	4,392	IBRD/IDA
Reston	Sprint Int'l Communication Corp.	1,049	IBRD/IDA
Reston	Sprint Int'l Communication Corp.	656	IBRD/IDA
Reston	U.S. Department of the Interior	9	AFDB
Richmond	Hunton & Williams	950	IBRD/IDA
Richmond	Universal Leaf Tobacco Co.	142	IBRD/IDA
Springfield	Ensco Inc.	3,140	IBRD/IDA
Springfield	Ensco Inc.	326	IBRD/IDA
Sterling	Sutron Corp.	82	IDB
Troy	Cable Form Inc.	16	IDB
Unspecified	Barltrop Associates	7	IBRD/IDA
Unspecified	DBA Routenberg Associates	62	IBRD/IDA
Unspecified	Donna Edgerton	28	IBRD/IDA
Unspecified	IBS Management Trading Center	126	IBRD/IDA
Unspecified	Infilco Degremont Inc.	636	IBRD/IDA
Unspecified	Int'l Commerce & Comm. Inc.	150	IBRD/IDA
Unspecified	Joy E. Hecht	20	IBRD/IDA
Unspecified	Kwesi Mducm	131	IBRD/IDA
Unspecified	Onsi Savris & Co.	1,848	IBRD/IDA

VIRGINIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Stanley C. Silverberg	47	IBRD/IDA
Unspecified	Undetermined	2,050	IBRD/IDA
Unspecified	United Suppliers Int'l	202	IBRD/IDA
Unspecified	United Suppliers Int'l	101	IBRD/IDA
Vienna	Bengtsson Int'l	10	IIC
Vienna	Bengtsson Int'l	10	IIC
Vienna	Dobbin Milus Int'l Inc.	1,195	ADB
Waynesboro	Genicom Corp.	135	IBRD/IDA
Winchester	VDO Yazaki Corp.	813	IBRD/IDA
State Total		53,495	

WASHINGTON

CITY	COMPANY	AMOUNT ($'000)	BANK
Kirkland	Sierra Geophysics	317	IBRD/IDA
Normandy Park	Charles Doan	38	IDB
Pullman	Carlos Esteban Suarez	4	IDB
Redmond	R. Lynette & Associates	150	IDB
Redmond	R. Lynette & Associates	150	IDB
Redmond	R. Lynette & Associates	5	IDB
Seattle	Boeing Commercial Airline Co.	515	IBRD/IDA
Seattle	Hatch & Kirk Inc.	256	IDB
Seattle	Hatch & Kirk Inc.	256	ADB
Seattle	Hatch & Kirk Inc.	200	IDB
Seattle	Management Advisory Services Inc.	62	IDB
Seattle	Management Advisory Services Inc.	29	IDB
Seattle	Nature Conservancy	30	IDB
Unspecified	Scott & Scott Systems Inc.	201	IBRD/IDA
Unspecified	Undetermined	6,290	IBRD/IDA
Vancouver	Larcen Electric	1	IDB
State Total		8,504	

WEST VIRGINIA

CITY	COMPANY	AMOUNT ($'000)	BANK
Fairmont	Eimco Coal Machinery	3,513	IBRD/IDA

WISCONSIN

CITY	COMPANY	AMOUNT ($'000)	BANK
Brookfield	Harnischfeger Corp.	2,210	IBRD/IDA
Delavane	Perkins-Berkeley	120	IDB
Fontana	Educational Innovation Systems Inc.	325	IBRD/IDA
Fontana	Educational Innovation Systems Inc.	71	IBRD/IDA
Madison	Blau Supply Inc.	5,664	IBRD/IDA
Madison	Extrel FTMS Inc.	292	IBRD/IDA
Madison	K. Mark Lawrence	19	EBRD
Madison	Nicolet Instrument Corp.	80	IDB
Madison	Ormson Corp.	149	IBRD/IDA
Madison	Pangaea Partners Ltd	244	EBRD
Madison	Pangaea Partners Ltd	82	EBRD
Madison	Pangaea Partners Ltd	58	EBRD
Madison	University of Wisconsin	1,439	IBRD/IDA
Madison	University of Wisconsin	65	IDB
Madison	World Council of Credit Unions Inc.	222	IBRD/IDA
Madison	World Council of Credit Unions Inc.	51	IDB
Madison	World Council of Credit Unions Inc.	34	IDB
Madison	World Council of Credit Unions Inc.	34	IDB
Madison	World Council of Credit Unions Inc.	30	IDB
Mequon	McClean Int'l Marketing Inc.	4	IDB
Middleton	National Electrostatics Corp.	716	IBRD/IDA
Milwaukee	Aldrich Chemical Co.	441	IBRD/IDA

WISCONSIN

CITY	COMPANY	AMOUNT ($'000)	BANK
Milwaukee	A.O. Smith Corp.	24,000	IFC
Milwaukee	Briggs & Stratton Corp.	144	IBRD/IDA
Milwaukee	Bucyrus-Erie Co.	1,606	IBRD/IDA
Milwaukee	Bucyrus-Erie Co.	216	AFDB
Milwaukee	Sta-rite	3,331	IBRD/IDA
Milwaukee	Sta-rite	257	IBRD/IDA
Milwaukee	University of Wisconsin	854	IBRD/IDA
Milwaukee	University of Wisconsin	545	IBRD/IDA
Milwaukee	University of Wisconsin	309	IBRD/IDA
New Berlin	Super Products Corp.	1,259	IBRD/IDA
Racine	J.I. Case Co.	3,119	IBRD/IDA
Racine	J.I. Case Co.	1,036	IBRD/IDA
Racine	J.I. Case Co.	424	AFDB
Racine	J.I. Case Co.	246	ADF
Racine	J.I. Case Co.	182	IBRD/IDA
Racine	J.I. Case Co.	153	IDB
Sheboygan	Vollrath Company Inc.	2	IDB
Unspecified	Allen Bradley Co.	134	IBRD/IDA
Unspecified	Boschetti - Marine Power Int'l	9	IBRD/IDA
Unspecified	Gaky Engineering	150	IBRD/IDA
Unspecified	J.M. Voith AG	39,000	IBRD/IDA
Unspecified	Terra Institute	165	IBRD/IDA

WISCONSIN

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	Undetermined	1,125	IBRD/IDA
Walworth	Edusystems Inc.	2,866	IBRD/IDA
Walworth	Edusystems Inc.	2,221	IBRD/IDA
Walworth	Edusystems Inc.	1,076	IBRD/IDA
Walworth	Edusystems Inc.	733	IDB
Walworth	Edusystems Inc.	527	IBRD/IDA
Walworth	Edusystems Inc.	370	IDB
Walworth	Edusystems Inc.	370	IDB
Walworth	Edusystems Inc.	367	IBRD/IDA
Walworth	Edusystems Inc.	329	IBRD/IDA
Walworth	Edusystems Inc.	226	IDB
Walworth	Edusystems Inc.	162	IDB
Walworth	Edusystems Inc.	83	IDB
Walworth	Edusystems Inc.	29	IDB
Walworth	Edusystems Inc.	22	IDB
Waukesha	Dresser Industries Inc.	537	IBRD/IDA
Waukesha	General Corp.	76	IDB
Wausau	Marathon Electric	244	IDB
State Total		100,854	

UNDETERMINED

CITY	COMPANY	AMOUNT ($'000)	BANK
Unspecified	American Pulp	70	.\FDB
Unspecified	Biscayne Engineering Co.	993	IDB
Unspecified	Debevoise & Plimpton	175	IDB
Unspecified	Dore & Pitt	428	AFDB
Unspecified	Int'l Diesel Electric Inc.	76	ADB
State Total		1,742	

PART III

INTERNATIONAL TRADE ADMINISTRATION

INTERNATIONAL TRADE ADMINISTRATION

The Department of Commerce's International Trade Administration (ITA) offers a wide range of services and support to U.S. business firms that operate or seek to operate internationally. These services are made available through the International Trade Administration and other offices in the Department of Commerce.

The ITA has domestic and foreign offices, staffed by commercial officers, country experts, and industry experts. Country Desk Officers collect information on foreign country's regulations, tariffs, business practices, economic and political developments, trade data, market size and growth, and keep current on the market for U.S. goods and services in their respective countries. Industry specialists work with manufacturing and service industry associations and firms to identify trade opportunities and obstacles by product or service, industry sector, and market.

The International Trade Administration includes the U.S. Foreign & Commercial Service (US&FCS), which has offices domestically and abroad. There are US&FCS offices in 71 cities in the United States. Its foreign offices are located in U.S. embassies and consulates in 133 cities in 67 foreign countries. There is a contact list for domestic and international Commercial Service offices in Part IV of this report.

The US&FCS directly assists firms interested in development banks through the Office of Multilateral Development Banks Operations (MDBO). This office, established in 1993, is located at the main Commerce Department building in Washington, D.C. It provides one-stop shopping services to U.S. firms interested in doing business through the multilateral development banks.

The MDBO also directs the activities of the senior commercial officers who have been placed in the U.S. Executive Directors Office at each of the development banks. These officers act as U.S. business advocates within the development banks. The MDB Contact list in Part V of this report includes the senior commercial officers.

The MDBO assists U.S. companies in obtaining contract opportunities available through projects funded by the multilateral development banks. It disseminates advance information on projects being developed by borrowing countries and the development banks. It provides information and assistance in doing business with the private sector branches of the development banks, such as the International Finance Corporation (IFC).

The MDBO works closely with a host of multiplier organizations--including state and local economic development offices, world trade centers, chambers of commerce, and trade associations.
It collaborates with export promotion and financing agencies within the U.S. government. These agencies include the Export-Import Bank, the Trade and Development Administration, the Overseas Private Investment Corporation, the Agency for International Development, and the Small Business Administration.

The U.S. and Foreign Commercial staff and members of the staff from the development banks also participate each year in a large number of conferences and seminars that are held throughout the U.S. and overseas. These conferences and seminars are designed to brief U.S. companies on the business opportunities that are available to them through the development banks.

The MDBO maintains a Counseling Center to provide assistance in developing competitive strategies for obtaining contracts, and acts as an advocate on behalf of U.S. firms. Since its inception, the Center has provided counseling to around 60 businesses per week, many of them new to the development bank market. Contact information is available in the appendix under the Office of Multilateral Development Bank Operations.

The Center has a library of project documents available for the World Bank, Inter-American Development Bank, European Bank for Reconstruction and Development, Asian Development Bank, and the African Development Bank. In 1994, the Asian Development Bank established the Counseling Center as a public depository library for its key documents.

The US&FCS also manages, in conjunction with the Small Business Administration and the Export-Import Bank of the United States, four regional Export Assistance Centers located in Baltimore, Chicago, Miami, and Long Beach. These "One Stop" shops provide the combined export marketing and trade finance assistance which small- and medium-sized companies need.

The Commerce Department plans to open 11 more regional Export Assistance Centers during 1995-- in Boston, Cleveland, Denver, Seattle, St.Louis, New Orleans, Dallas, Philadelphia, New York, Atlanta, and Detroit. Each center represents an interagency effort to combine the services of several trade finance and export promotion agencies.

The Department of Commerce provides an important service to other U.S. government agencies and the U.S. business community through its in-house electronic network. This network includes the Economic Bulletin Board (EBB) and the National Trade Data Bank (NTDB). The Center's computer terminals provide free public access to the EBB and the NTDB, which contains a vast array of international trade and market information. Center staff counsel U.S. companies on how to access and utilize development bank information on the EBB and through the Internet. The EBB is the world's leading source of government sponsored trade and economic information. Begun in 1985, it is the most used computer bulletin board of its kind. It provides up-to-the-minute coverage of trade information, and is available 24 hours a day, 7 days a week.

Each month the Department of Commerce transfers selected information from its Economic Bulletin Board into the National Trade Data Bank in CD ROM format. The NTDB combines trade information from over 20 different federal agencies and is available at all district offices of the Commerce Department, 1,000 Federal Depository libraries, the Office of Multilateral Development Bank Operations. It is also available on a subscription basis. The NTDB contains monthly updates of the operational summaries for each of the development banks, as well as over 18,000 embassy reporting cables on significant sector and country economic trends. Additional information on subscription costs and access can be obtained from the NTDB/EBB Help Line on 202-482-1986.

For more information on ITA, as well as other Federal and State export programs, you can call the "One-Stop" Trade Information Center on 1-800-USA-TRADE. For questions on development banks, you can contact the Office of Multilateral Development Banks listed in the Part V or contact the Procurement Officer located in the U.S. Executive Directors' offices in each of the Banks.

PART IV

CONTACT LIST

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U.S. DEPARTMENT OF COMMERCE
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U.S. AND FOREIGN COMMERCIAL SERVICE
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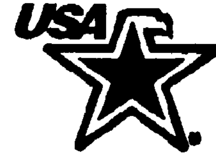
JANUARY 17, 1995



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SCO Steve Herdry
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Guangzhou
American Consulate General
FCSO Robert Strotman
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96655-0002
Tel: 011-86-20-666-338
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Shanghai
American Consulate General
FCSO David Murphy
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Shenyang
American Consulate General
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COLOMBIA
Bogota
American Embassy
SCO Catherine Houghton
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COSTA RICA
San Jose
American Embassy
SCO Maria Galindo
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COTE D'IVOIRE
Abidjan
American Embassy
SCO Aikki Brajevich
U.S. Dept of State (Abidjan)
Washington, DC 20521-2010
Tel: 011-225-21-46-16
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CROATIA
Zagreb
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CZECH REPUBLIC
Prague
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DENMARK
Copenhagen
American Embassy
SCO Richard Benson
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DOMINICAN REPUBLIC
Santo Domingo
American Embassy
SCO Robert Bucalo
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ECUADOR
Quito
American Embassy
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U.S. AND FOREIGN COMMERCIAL SERVICE—OVERSEAS POSTS

EGYPT

Cairo
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Alexandria
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FINLAND

Helsinki
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FRANCE

Paris
American Embassy
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Lyon
American Consulate General
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Marseille
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Nice
U.S. Commercial Office
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Strasbourg
American Consulate General
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GERMANY

Bonn
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U.S. Dept. of State
Washington, DC 20521-5180
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FCSO B. Lehne
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Munich
American Consulate General
FCSO Edward Ruse
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Stuttgart
American Consulate General
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GREECE

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HONDURAS

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HUNGARY

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Kingston
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Tokyo
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NETHERLANDS
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POLAND
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UNITED KINGDOM

London
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PART V

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IN

THE MULTILATERAL DEVELOPMENT BANKS

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Lisa Lumbao
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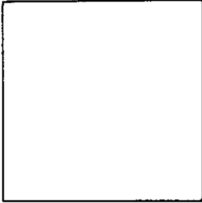

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PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
June 5, 1995

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $14,218 million of 13-week bills to be issued June 8, 1995 and to mature September 7, 1995 were accepted today (CUSIP: 912794U77).

RANGE OF ACCEPTED
COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.42%	5.59%	98.630
High	5.48%	5.65%	98.615
Average	5.48%	5.65%	98.615

Tenders at the high discount rate were allotted 72%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

	Received	Accepted
TOTALS	$42,350,503	$14,218,041
Type		
Competitive	$36,921,870	$8,789,408
Noncompetitive	1,432,191	1,432,191
Subtotal, Public	$38,354,061	$10,221,599
Federal Reserve	3,287,155	3,287,155
Foreign Official Institutions	709,287	709,287
TOTALS	$42,350,503	$14,218,041

An additional $1,413 thousand of bills will be issued to foreign official institutions for new cash.

5.43--98.627 5.44--98.625 5.45--98.622
5.46--98.620 5.47--98.617

RR-344

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
June 5, 1995

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $14,220 million of 26-week bills to be issued June 8, 1995 and to mature December 7, 1995 were accepted today (CUSIP: 912794V92).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.32%	5.56%	97.310
High	5.35%	5.59%	97.295
Average	5.35%	5.59%	97.295

Tenders at the high discount rate were allotted 76%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

	Received	Accepted
TOTALS	$45,390,533	$14,220,380
Type		
Competitive	$38,717,215	$7,547,062
Noncompetitive	1,327,805	1,327,805
Subtotal, Public	$40,045,020	$8,874,867
Federal Reserve	3,450,000	3,450,000
Foreign Official Institutions	1,895,513	1,895,513
TOTALS	$45,390,533	$14,220,380

An additional $3,687 thousand of bills will be issued to foreign official institutions for new cash.

5.33 - 97.305, 5.34 - 97.300

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

FOR IMMEDIATE RELEASE
June 5, 1995

Contact: Chris Peacock
(202) 622-2960

STATEMENT BY TREASURY SECRETARY ROBERT RUBIN

Today's indictments of the leaders of the Cali drug cartel and their associates is the result of a four-year investigation led by the U.S. Customs Service. I am proud of the superb effort of the Customs Service, working with the Drug Enforcement Administration. This case is a tremendous example of the dedicated, patriotic work performed every day by federal law enforcement agents.

This investigation shows the Administration's continuing commitment to fighting drug trafficking on all fronts. I'm confident the Treasury Department, through our law enforcement bureaus, will continue to be vigilant in protecting our borders against illegal drugs and money-laundering from criminal activities.

-30-

RR-346

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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For Release Upon Delivery
Expected at 2:30 p.m.
June 6, 1995

STATEMENT OF TREASURY SECRETARY ROBERT E. RUBIN
BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to appear before the Finance Committee today in my role as Managing Trustee and Chairman of the Medicare Board of Trustees. The Board is required to report annually to the Congress on the financial status of two separate Medicare trust funds -- the Hospital Insurance (or HI) Trust Fund and the Supplementary Medical Insurance (or SMI) Trust Fund.

As you know, this year's report shows that the HI Trust Fund will be exhausted by the year 2002 and that the costs of the SMI program continue to rise rapidly. The Board has repeatedly notified Congress about the HI Trust Fund's short-term insolvency. This Administration clearly recognizes that the projected Medicare shortfall needs to be addressed.

The Medicare financing problem is a complex interaction of demographics and the rapidly rising costs that affect all parts of our health care system. We need to carefully reform Medicare, in the context of health care reform, in order to get the best possible solution for both the short term and long term. Or, to put the same matter differently, the Administration believes that the growth of federal health care expenditures, including Medicare, needs to be reduced in order to control the budget. But reducing this growth must be done by carefully weighing trade-offs and reforming these programs in the context of health care reform. Only such a process will lead to an outcome that best meets the multiplicity of objectives that need to be considered.

The alternative is arbitrary attempts to resolve the financing crisis that may restore solvency to the HI Trust Fund, but will create and intensify other problems. Specifically, we are concerned that deep reductions in Medicare may cause cost shifting, which could raise health care costs in the private sector, reduce private insurance coverage, and increase outlays for other government programs.

RR-347

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The Trustees have provided the Congress with an early warning and it is time to develop effective Medicare reforms in the context of health care reform, an objective this Administration has energetically pursued since it first took office in January of 1993. But we do have enough time to fix it right, even if we have to do it in stages, so that we avoid a hasty, unworkable solution that may have to be undone in the future.

The Medicare program merits this type of careful consideration because it is crucial to a large number of our citizens. One of the most important things our country has done over the past 30 years has been to work to reduce poverty and deprivation among senior citizens and disabled persons, and thereby also reduce the burden on and the anxiety of their children. Medicare has effectively provided a reliable source of medical care coverage for aged and disabled Americans. There are few issues of greater concern to working families than the cost of retirement and the problem of providing health care to the elderly.

Changes to Medicare as part of health care reform can restore Medicare to financial soundness, while at the same time improving the health of elderly and disabled Americans. As I mentioned a few moments ago, the Clinton Administration has sought to work with Congress -- since the Administration first came to office -- to solve the current Medicare financing problem and the more general health care crisis.

Financial Status of the Medicare Trust Funds

As noted, the Trustees reported in April that the HI Trust Fund will be exhausted in 2002, one year later than projected last year. This slight improvement largely reflects the effects of the President's 1993 deficit reduction plan, the stronger-than-expected economy in 1994, and lower-than-expected program cost increases. Since this Administration took office, the exhaustion date has been extended by three years.

Over the long term, the 75-year actuarial deficit (interpreted as the amount of payroll tax increase or benefit reduction needed now to balance the trust fund over the next 75 years) was reduced from last year's estimate of 4.14 percent to 3.52 percent of payroll. The reduction is largely the result of lower expected future increases in HI costs, based on the recently observed slowdown in HI spending growth. Despite the decline, the HI program remains substantially out of long-run actuarial balance, and that problem is not addressed by either of the current Congressional budget resolutions.

The Trustees also continue to project rapid growth in Supplementary Medical Insurance program costs well into the future. Over the next five years, outlays are expected to increase 78 percent in the aggregate and 66 percent per enrollee. During the same period, the program is expected to grow about 38 percent faster than the overall economy.

Combined HI and SMI costs are expected to increase from 2.6 percent of GDP in 1995 to 8.8 percent in 2069 -- roughly tripling -- largely due to anticipated demographic changes. Because of this rise in long-term program costs and the expected exhaustion of the

HI Fund in 2002, the Board of Trustees recommends effective Medicare reform, but again, we believe that this must be done with a careful weighing and balancing of all impacts and all considerations and in the context of health care reform.

History of Medicare Costs

When the Hospital Insurance program has faced financing problems in the past, Congress and the Executive Branch have been able to cooperate on making modest changes in the program that slowed the rate of cost increases.

The program has experienced financial difficulty since its inception in 1966 because of rapidly rising hospital costs, higher-than-expected utilization, and program expansion. The actuarial balance deteriorated between 1966 and 1972, leading to an increase in payroll taxes in 1972 and temporary control of hospital prices between 1972 and 1974. After 1974, annual hospital costs again increased rapidly until 1983 legislation changed the manner in which Medicare pays for hospital services (from a retrospective to a prospective basis). As a result, the annual growth of hospital costs was modest in the mid-1980s.

During the 1990s, program expenditure increases were below those of the previous decade, reflecting a comparatively moderate rise in overall health care inflation and utilization. The President's 1993 deficit reduction plan, which included Medicare spending cuts, removal of the earnings limit for HI contributions, and increased taxation of OASDI benefits (with the proceeds going to the HI Trust Fund), is partly responsible for the recent decline in growth rates and the increase in revenues which, together, extended the trust fund exhaustion date by three years.

Technically the SMI Trust Fund is actuarially sound, but only because the majority of its funding is from general revenue. Spending for physician services has grown faster than spending for hospital services in recent years. This is due, in part, to the establishment, in 1983, of Medicare's prospective payment method for hospital services. This payment procedure, among other things, provided hospitals with an incentive to shift some services from an inpatient to an outpatient setting, where services were not reimbursed on a prospective basis. In 1992, the SMI program began to phase in a fee schedule based on the estimated cost of resources used to provide various physician services. Although this change should help restrain the future growth of SMI expenditures, SMI and HI face similar near-term financial pressures because of medical price inflation and rising utilization of services. Over the long term, demographic change will dominate, as an aging population compounds the financing problem for both programs.

Medicare Financing and Health Care Reform

The fundamental reason for the rise in Medicare expenditures is the increase in health care costs affecting all parts of the nation's health care system. A dramatic attempt by government to contain Medicare spending in a vacuum -- for example, through large

reductions in payments to hospitals -- will cause significant distortions and inefficiencies elsewhere in the health care system, unless such a reduction is undertaken in the context of health care reform.

Medicare cuts of the magnitude proposed in the House and Senate budget resolutions, if not accompanied by health care reform, will harm the most vulnerable in society -- the elderly and the disabled -- and may cause doctors, hospitals, and other health care providers to shift costs to everyone else. That means that working families will face higher private insurance premiums or will lose their insurance coverage. In addition, Medicare cuts of this magnitude, without any other reforms, could lead to the closing of already scarce rural hospitals; real pressures on big, urban public hospitals and academic health centers; and reduced services to many vulnerable people through cutbacks in payments for uncompensated care.

In contrast, much more can be done to strengthen the Medicare program if we undertake health care reform. Taking steps to extend health insurance coverage to the uninsured population, and developing, through insurance reform, a competitive health care market will create a more efficient system. This increased efficiency will slow the growth in overall health care spending and provide long-term savings to the Medicare program.

In closing, the Administration believes it is possible to address the HI Trust Fund problem, the rising costs in the rest of the Medicare program, and broader health care reform objectives in a thoughtful manner, and produce effective, acceptable solutions that will stand the test of time. We are ready, and we have been from the beginning of this Administration, to work with the Congress to achieve these goals.

will be happy to answer any questions you may have.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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Adv. 10 a.m. EDT
Remarks as prepared for delivery
June 6, 1995

REMARKS OF TREASURY SECRETARY ROBERT E. RUBIN
CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

As you know, the President, Secretary Christopher and I will be in Halifax next week for a G-7 summit, at which discussions will include, among other things, how our international financial institutions can serve as well in the next half century as they have for the past half century.

The challenges facing the world 50 years ago were immense: rebuild Europe and Japan; restore lost industrial capacity; rebuild the physical infrastructure of entire nations; and deal with refugee problems.

It was in that context that the United States, working closely with our allies, led the world in creating the Bretton Woods institutions. It was a remarkable time, and the response was of historic importance. We saw in rapid order the Marshall Plan, the creation of NATO and the United Nations, the World Bank and the IMF.

The intervening half century has seen enormous changes, economically and politically. I want to briefly discuss that economic history, because those changes, along with the new post-Cold War political era, are the framework for discussion today.

Europe has been rebuilt and regained its prosperity. The former Warsaw Pact nations are undergoing an historic economic and political transformation. Japan is now the world's second-largest economy. Over the past decade, Asia and Latin America have become, respectively, the fastest and second-fastest growing regions of the world. Trade barriers have begun to fall with the recognition that growth and protectionism are incompatible.

Economic health is now the global binding agent. Ensuring that that bond holds is critical to all our interests and to the next chapters in global history.

RR-348 (MORE)

However, we face new challenges. To be certain that the gains of the past 50 years are not at least in part squandered, we must do everything possible to equip the international financial institutions to meet those challenges, and to address other areas such as trade market regulation that are critical to meeting those challenges.

I want to examine the challenges the world faces, and discuss what I believe is necessary for the future.

The challenges are first, to develop effective multilateral mechanisms to deal with the problems that may arise from the vast increase in the speed and size of the international financial markets, and to minimize systemic risk from those markets. Our institutions must be made as modern as the marketplace. The second is to promote economic reform and development in the developing world, where five-sixths of the world's population resides and where much of the world's future growth will occur. The third is to assist in the transformation of the former communist world into the economic mainstream. And the fourth is to continue the movement towards opening markets.

The United States and the international financial institutions are dealing now with the issue of Mexico's financial difficulties. Free flows of capital are essential to support strong, sustainable development, but with Mexico we also have seen how poor policies and markets that lack depth, in very short order, can destroy a nation's finances and threaten the spread of financial instability.

How do we deal with the potential for problems created by modern financial markets?

First, we need a better capacity and arrangement to avert financial crises. This must rely primarily on greater and more timely disclosure of financial data to the markets; in other words, timely and sufficient transparency. Market reaction should then prevent the build-up of a dangerous situation in most cases. That is one of the primary lessons of Mexico's difficulties. The principle of disclosure is at the heart of the regulatory system in the United States, and that principle could serve very powerfully in the global financial arena with respect to sovereign issuances. Moreover, the IMF must develop a greater capacity for surveillance, so that it too can play a powerful preventative role.

Second, the international economy needs enhanced mechanisms to rapidly mobilize relatively large amounts of conditional financial assistance when problems of sufficient importance develop. The United States cannot be the lender of last resort to the world. The multilateral institutions need the capacity to deal with such crises.

We want to build on existing mechanisms and expand those arrangements to include countries who benefit from a stable international monetary system and who now have the resources to contribute to maintaining that stability, including the newly prosperous nations of Asia.

Third, there is merit in the cautious exploration of orderly work-out mechanisms to deal with international debt crises. We no longer have the luxury of bringing in a few major creditors to find a solution. The financial world has changed too much. The system would benefit from an arrangement that would involve the broader range of creditors with a stake in resolving debt problems.

Fourth, steps should be taken to deal with the issue of regulation with regard to financial markets and the risk of systemic crises arising, not from sovereign defaults but from the financial markets and their particular nature. Our financial regulators must cooperate more fully in supervising financial institutions and financial instruments as our financial system evolves. We cannot eliminate this type of systemic risk, but we can better monitor and limit it.

We must also determine how we can encourage reform and growth in developing countries, assist economies in transition, and continue lowering trade barriers.

First, we need to continue to work for a solution for the world's poorest countries that, despite their best efforts, cannot meet much of their debt obligation. The United States has pledged to do its share, along with other creditors, to reduce this debt and help them get back on their feet. With a small amount of funding we can leverage substantial debt reduction through the participation of other developed nations and improve prospects for growth and trade.

Second, we must recognize the problems faced by economies emerging from conflict, the problems of economies in transition such as Russia and Ukraine, and focus on how the banks and the IMF deal with these issues. Building prosperity in regions such as the Middle East, for example, is one of the surest ways to promote stability.

Third, we must continue opening markets and leveling the playing field, as we did with NAFTA, the GATT and the WTO, and as we are doing by building towards a free trade agreement in this hemisphere and throughout the Asia and Pacific region.

And fourth, on a broader scale, the multilateral development banks themselves must look to the long term. They must continue moving towards greater priority on primary education, particularly for women, on health care, and on environmental preservation. They also must ensure that their lending supports, not supplants the private sector, the driving force in market economies. The banks must continue becoming more efficient and more transparent. These institutions have come a great distance in the past few years, with the United States playing a major leadership role, but much more remains to be done.

I said at the outset that Halifax is a way station in an evolutionary process. At Halifax we can review the progress that has occurred in all these areas, and give the international financial institutions the guidance to meet their global challenges I've outlined.

The one element absolutely essential to meeting those challenges is the leadership of the United States. The future prosperity and security of the United States requires that our nation remain engaged and lead globally in opening markets, in promoting development, in assisting economies in transition, and in dealing with global financial problems.

We led on NAFTA, on GATT, and on the WTO, and that is in our interest. We assisted Mexico and are leading the effort to assist the transforming economies, because it is in our interests. And, we are working to ensure that we properly support the international financial institutions, because that is in our interests. What is at stake is the security and the future prosperity of all Americans. Turning our back on the world, lessening our engagement and retreating will only endanger what we have worked so hard to achieve these past 50 years. That must not be permitted to happen.

There is a new isolationism afoot, and it must be aggressively countered. Recall if you will how difficult it was to get the trade treaties through Congress. Let me talk for a moment about how an issue you might not have considered recently, support for reform and growth in developing countries.

At the center of this debate is that tiny fraction of the federal budget devoted to these institutions. In helping to strengthen economic growth in Latin America, build markets in Eastern Europe and the former Soviet Union, reduce poverty in Africa and Asia, and support peace in the Middle East, these institutions provide vital support for U.S. global objectives on a scale which cannot be replicated by our bilateral programs. Moreover, the IMF, the World Bank, and the development banks can influence changes that would be impossible for the United States to do bilaterally.

I want speak to our participation in the International Development Association and the IMF's Enhanced Structural Adjustment Facility, those portions of the World Bank and IMF lending that promotes growth in the poorest countries and encourages those countries to make economic and social reforms, open markets, privatize, reform their financial sectors and reduce poverty. These are among our most important foreign policy tools for integrating the poorest nations into the global economy, which, again, is in our economic and national security interest.

IDA is a sound long-term investment for the United States. Last year, we exported $42 billion to the 20 nations which have graduated from IDA economic reform programs, and $20 billion to countries currently in those programs. Dropping out of IDA -- which has an extensive history of bipartisan support -- would undercut economic growth and reform across the globe, and undercut American leadership in global affairs. We cannot isolate ourselves from a world in political and economic transition. It is imperative that the Congress fund our request for the international financial institutions, most of which is for IDA.

To conclude, we should recall the lessons of leadership during periods of global transition. After World War I, the United States turned inward, raised the gates and ignored its responsibility. The consequences for the world and for us were disastrous. But the United States led the effort to create the international financial institutions following World War II -- looking toward the problems of the future. That leadership has produced remarkable results -- today's peace and greater economic prosperity, for us and the global economy.

Now, again, we face challenges -- different ones for a different time. What has not changed is the requirement for United States leadership.

Thank you.

-30-

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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FOR RELEASE AT 2:30 P.M.
June 6, 1995

CONTACT: Office of Financing
202/219-3350

TREASURY'S WEEKLY BILL OFFERING

The Treasury will auction two series of Treasury bills totaling approximately $28,400 million, to be issued June 15, 1995. This offering will result in a paydown for the Treasury of about $15,550 million, as maturing bills total $43,949 million (including the 13-day cash management bills issued June 2, 1995, in the amount of $17,126 million).

Federal Reserve Banks hold $6,658 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 $3,225 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) 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

RR-349

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HIGHLIGHTS OF TREASURY OFFERINGS OF WEEKLY BILLS TO BE ISSUED JUNE 15, 1995

June 6, 1995

Offering Amount	$14,200 million	$14,200 million
Description of Offering:		
Term and type of security	91-day bill	182-day bill
CUSIP number	912794 U8 5	912794 T6 1
Auction date	June 12, 1995	June 12, 1995
Issue date	June 15, 1995	June 15, 1995
Maturity date	September 14, 1995	December 14, 1995
Original issue date	March 16, 1995	December 15, 1994
Currently outstanding	$12,466 million	$17,078 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 Daylight Saving time on auction day

Competitive tenders . . . . Prior to 1:00 p.m. Eastern Daylight Saving 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

PUBLIC DEBT NEWS

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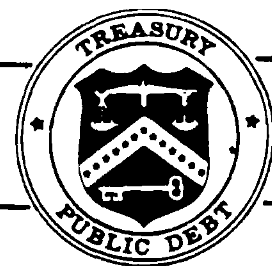

FOR RELEASE AT 3:00 PM
June 6, 1995

Contact: Peter Hollenbach
(202) 219-3302

PUBLIC DEBT ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR MAY 1995

Treasury's Bureau of the Public Debt announced activity figures for the month of May 1995, of securities within the Separate Trading of Registered Interest and Principal of Securities program (STRIPS).

Dollar Amounts in Thousands

Principal Outstanding (Eligible Securities)	$837,372,792
Held in Unstripped Form	$613,113,258
Held in Stripped Form	$224,259,534
Reconstituted in May	$12,251,058

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-186
(RR-350)

TABLE VI -- HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, MAY 31, 1995
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month #1
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
10-1/2% Note C-1995	08/15/95......	7,955,901	4,909,901	3,046,000	71,600
9-1/2% Note D-1995	11/15/95......	7,318,550	3,385,350	3,933,200	41,200
8-7/8% Note A-1996......	02/15/96......	8,449,835	6,691,435	1,758,400	65,600
7-3/8% Note C-1996......	05/15/96......	20,085,643	17,144,843	2,940,800	27,200
7-1/4% Note D-1996......	11/15/96......	20,258,810	17,510,010	2,748,800	20,800
8-1/2% Note A-1997......	05/15/97......	9,921,237	8,818,437	1,102,800	54,000
8-5/8% Note B-1997......	08/15/97......	9,362,836	7,697,236	1,665,600	12,800
8-7/8% Note C-1997......	11/15/97......	9,808,329	7,253,129	2,555,200	0
8-1/8% Note A-1998......	02/15/98......	9,159,068	7,951,388	1,207,680	20,160
9% Note B-1998..........	05/15/98......	9,165,387	6,760,387	2,405,000	61,000
9-1/4% Note C-1998......	08/15/98......	11,342,646	8,901,846	2,440,800	50,400
8-7/8% Note D-1998......	11/15/98......	9,902,875	7,123,675	2,779,200	54,400
8-7/8% Note A-1999......	02/15/99......	9,719,623	8,066,823	1,652,800	9,600
9-1/8% Note B-1999......	05/15/99......	10,047,103	6,832,703	3,214,400	57,600
8% Note C-1999..........	08/15/99......	10,163,644	7,965,094	2,198,550	127,000
7-7/8% Note D-1999......	11/15/99......	10,773,960	7,709,960	3,064,000	57,600
8-1/2% Note A-2000......	02/15/00......	10,673,033	8,642,633	2,030,400	10,400
8-7/8% Note B-2000......	05/15/00......	10,496,230	5,918,630	4,577,600	0
8-3/4% Note C-2000......	08/15/00......	11,080,646	7,412,006	3,668,640	2,080
8-1/2% Note D-2000......	11/15/00.....	11,519,682	8,256,882	3,262,800	48,000
7-3/4% Note A-2001......	02/15/01......	11,312,802	9,268,002	2,044,800	85,600
8% Note B-2001..........	05/15/01......	12,398,083	9,769,683	2,628,400	0
7-7/8% Note C-2001......	08/15/01......	12,339,185	9,945,585	2,393,600	9,600
7-1/2% Note D-2001......	11/15/01......	24,226,102	22,182,662	2,043,440	124,000
7-1/2% Note A-2002......	05/15/02......	11,714,397	10,871,277	843,120	5,200
6-3/8% Note B-2002......	08/15/02......	23,859,015	22,790,215	1,068,800	9,600
6-1/4% Note A-2003......	02/15/03......	23,562,691	23,112,323	450,368	11,072
5-3/4% Note B-2003......	08/15/03......	28,011,028	27,431,028	580,000	8,000
5-7/8% Note A-2004......	02/15/04......	12,955,077	12,955,077	0	0
7-1/4% Note B-2004......	05/15/04......	14,440,372	14,440,372	0	0
7-1/4% Note C-2004......	08/15/04......	13,346,467	13,315,267	31,200	0
7-7/8% Note D-2004......	11/15/04......	14,373,760	14,373,760	0	0
7-1/2% Note A-2005......	02/15/05......	13,834,754	13,834,754	0	0
6-1/2% Note B-2005......	05/15/05......	14,739,504	14,739,504	0	0
11-5/8% Bond 2004.......	11/15/04......	8,301,806	5,364,206	2,937,600	192,000
12% Bond 2005...........	05/15/05......	4,260,758	2,863,058	1,397,700	305,900
10-3/4% Bond 2005.......	08/15/05......	9,269,713	8,233,713	1,036,000	0
9-3/8% Bond 2006........	02/15/06......	4,755,916	4,753,164	2,752	0
11-3/4% Bond 2009-14....	11/15/14......	6,005,584	2,480,784	3,524,800	342,400
11-1/4% Bond 2015.......	02/15/15......	12,667,799	8,442,999	4,224,800	2,476,000
10-5/8% Bond 2015.......	08/15/15......	7,149,916	2,445,596	4,704,320	623,360
9-7/8% Bond 2015........	11/15/15......	6,899,859	2,443,859	4,456,000	88,000
9-1/4% Bond 2016........	02/15/16......	7,266,854	6,267,654	999,200	456,000
7-1/4% Bond 2016........	05/15/16......	18,823,551	18,335,551	488,000	0
7-1/2% Bond 2016........	11/15/16......	18,864,448	17,772,768	1,091,680	1,760
8-3/4% Bond 2017........	05/15/17......	18,194,169	7,566,169	10,628,000	663,520
8-7/8% Bond 2017........	08/15/17......	14,016,858	8,556,058	5,460,800	740,800
9-1/8% Bond 2018........	05/15/18......	8,708,639	1,919,839	6,788,800	340,800
9% Bond 2018............	11/15/18......	9,032,870	2,344,670	6,688,200	275,200
8-7/8% Bond 2019........	02/15/19......	19,250,798	5,375,598	13,875,200	304,000
8-1/8% Bond 2019........	08/15/19......	20,213,832	16,078,152	4,135,680	525,120
8-1/2% Bond 2020........	02/15/20......	10,228,868	5,083,268	5,145,600	300,000
8-3/4% Bond 2020........	05/15/20......	10,158,883	3,200,003	6,958,880	315,840
8-3/4% Bond 2020........	08/15/20......	21,418,606	4,865,806	16,552,800	950,400
7-7/8% Bond 2021........	02/15/21......	11,113,373	10,186,973	926,400	262,400
8-1/8% Bond 2021........	05/15/21......	11,958,888	4,579,048	7,379,840	310,080
8-1/8% Bond 2021........	08/15/21......	12,163,482	4,786,202	7,377,280	176,320
8% Bond 2021............	11/15/21......	32,798,394	8,147,894	24,650,500	631,750
7-1/4% Bond 2022........	08/15/22......	10,352,790	7,255,190	3,097,600	216,000
7-5/8% Bond 2022	11/15/22......	10,699,626	2,874,026	7,825,600	414,400
7-1/8% Bond 2023	02/15/23......	18,374,361	14,427,161	3,947,200	99,200
6-1/4% Bond 2023	08/15/23......	22,909,044	22,593,300	315,744	61,056
7-1/2% Bond 2024	11/15/24......	11,469,662	8,854,702	2,614,960	134,240
7-5/8% Bond 2025	02/15/25......	11,725,170	11,033,970	691,200	0
Total................	....	837,372,792	613,113,258	224,259,534	12,251,058

#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 p.m. 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.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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For Release Upon Delivery
Expected at 9:30 A.M.
June 7, 1995

STATEMENT OF
CYNTHIA G. BEERBOWER
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to present the views of the Treasury Department on proposals (i) to increase unified estate and gift tax exclusions and exemptions and (ii) to increase the expensing limit for small business.

1. The Administration has strongly supported and will continue to support the goal of assisting and strengthening small businesses.

The Administration previously has undertaken both legislative and administrative initiatives to achieve the goal of assisting and strengthening small businesses. In 1993, we proposed and supported the 50-percent exclusion for capital gains that result from the sale of small business stock; we supported the enactment of Section 1044, encouraging investment in small businesses by allowing gain from selling publicly traded stock to be invested tax-free in specialized small business investment companies; and we supported the increase in the amount of capital investment that small businesses can expense from $10,000 to $17,500.

Administratively, we issued numerous regulations designed to minimize or eliminate burdensome record-keeping requirements for small businesses. This year, we have reduced the reporting requirements necessary to claim an ordinary loss deduction on the sale of small business stock. Last year, we issued a variety of guidances to reduce compliance burdens on small businesses and to provide them with more flexibility. For example, we issued guidances which:

-- simplified the calculation for computing alternative minimum tax liability;

-- simplified the determination of depreciation deductions, allowing taxpayers to group certain assets in one or more "general asset accounts";

RR-351

-- clarified that S corporations may enter into partnerships with partners that could not themselves qualify as S corporations, including nonresident aliens. This guidance gives S corporations flexibility to raise additional capital and structure their business relationships as required;

-- clarified that employees did not have any income from the employer's non-deductible portion of business meals and entertainment, so long as there was a business purpose for the expense;

-- clarified that small investment partnerships, including family partnerships, can take advantage of a simplified form of accounting for the built-in gains or losses on their securities; and

-- provided that the rules governing the timing of hedging gains and losses do not apply to small cash-method taxpayers, even though such taxpayers are given the benefit of the favorable character provisions in those regulations.

Similarly, in 1993, we issued mark-to-market regulations that contain an exception for taxpayers with relatively low levels of sales activity, and we issued uniform capitalization rules that provide a de minimis rule for small businesses.

We expect to reduce needless administrative and compliance costs by proposing that taxpayers be allowed to elect to be treated as a partnership by simply checking a box on a return. This simplified approach would replace the current rules, under which small businesses could get partnership tax treatment only by complying with a multi-factored test that is both complex and uncertain in its application. This check-the-box approach has been uniformly praised by taxpayers and practitioners.

2. Increase of the Estate Tax Exemption and Addition of Estate and Gift Tax Indexing Provisions

Summary

The Administration recognizes that the estate-tax exemption has not been increased since 1987. We are concerned, however, that the House-passed proposal to increase the exemption and provide indexing would cost about $20 billion over 10 years and would affect a limited number of taxpayers -- less than 15,000 taxpayers per year would benefit from the proposed increase in the exemption. We would be willing to work with the Congress to develop and pay for targeted proposals that would provide benefits for small family businesses.

Background

The first estate tax was enacted in 1916. The present gift tax was added in 1932 to prevent avoidance of the estate tax through lifetime transfers. The initial estate tax was progressive, with rates varying from one to ten percent. Over the years, the highest marginal rate was greatly increased, reaching its maximum of 77 percent for the period from 1940 to 1976. At present, the marginal rates range from 18 to 55 percent. The 55 percent rate applies to taxable estates of $3,000,000 or more.

From the outset, a certain amount of property was exempted from the tax. Prior to the unification of the estate and gift tax systems in 1976, each taxpayer was allowed a specific exemption from the estate tax and a separate specific exemption from the gift tax. In 1976, the estate tax exemption was $60,000, and the gift tax exemption was $30,000.

These exemptions were converted into a credit in the Tax Reform Act of 1976. That act made major structural changes in the estate and gift taxes by unifying the estate and gift tax systems, applying a single progressive rate schedule to the aggregate transfers made by gift during life and at death. The exemption was changed to a credit to equalize the benefit received by smaller and larger estates.

The amount of the unified credit has been increased over time to account for inflation (see Chart 1 below). When Congress introduced the unified credit in 1976, it replaced the $60,000 estate-tax specific exemption which had been in effect since 1942. By 1976, the purchasing power of a dollar had decreased to less than one-third of its 1942 value. Under the Tax Reform Act of 1976, the phased-in unified credit effectively exempted from taxation the first $175,625 of an estate (a unified credit of $47,000) in 1981. These exemptions had the effect in 1977 of subjecting only 7.6 percent of decedents to the estate tax.

Congress reexamined the unified credit in the Economic Recovery Tax Act of 1981 (ERTA), again determining that the unified credit had failed to keep pace with inflation. The Senate Report stated:

> Inflation has increased the dollar value of property and, therefore, the transfer tax burdens, without increasing real wealth. With the existing level of unified credit (which permits cumulative tax-free transfers of $175,625), the estate tax is imposed on estates of a relatively small size, including those containing family farms or closely held businesses.

> Imposing the tax on these smaller, illiquid estates often results in forced sales of family enterprises.

S. Rep. 97-144, 97th Cong., 1st Sess. 124 (1981). ERTA increased the amount of the effective exemption over the five-year period from 1982 through 1987, from $175,625 (a unified credit of $47,000) to $600,000 (a unified credit of $192,800). The unified credit has remained unchanged since 1987.

CHART 1

History of the Unified Credit

Year	Credit Amount	Which Exempts the First
1977	$30,000	$120,666
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,560
1981	47,000	175,625
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987-Present	192,800	600,000

Current Law

Under current law, the "unified credit" effectively exempts from the federal estate tax the first $600,000 of an estate's value. This credit essentially removes from the estate tax system estates with assets of $600,000 or less. The unified credit can also be used to exempt lifetime gifts from the gift tax, but doing so reduces the amount of the credit available at death. If a married couple plans their estates carefully, both spouses' unified credits can be used to pass $1,200,000 to their children or other persons without imposition of any estate or gift tax. The credit is phased out for estates in excess of $10,000,000. The amount of the unified credit has been unchanged since 1987.

In addition to the amount that can be transferred without tax by gift or bequest due to the application of the unified credit, each taxpayer also may make annual tax-free gifts of up to $10,000 per recipient. A married couple together may make annual gifts of $20,000 per recipient. The annual exclusion does not apply to gifts of future interests (such as reversions or remainder interests). The amount of the annual exclusion has been unchanged since 1982.

A generation-skipping transfer tax ("GST tax") generally is imposed on direct and indirect transfers to a person in a generation more than one generation below that of the transferor. This tax is in addition to the estate or gift tax. Each taxpayer is allowed an exemption from the GST tax of $1,000,000 for generation-skipping transfers occurring during the taxpayer's lifetime or at death. The exemption amount was fixed at $1,000,000 when the GST tax was enacted in 1986 and has remained unchanged.

The estate tax includes relief provisions for farms and family businesses. Under Code Section 2032A, for example, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely held business at its current use value, rather than its highest and best use value. When Congress adopted this provision in 1976, it was concerned that a fair market valuation would make "continuation of farming, etc. activities not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus the heirs may be forced to sell the land for development purposes." S. Rep. 94-938, 94th Cong., 2d Sess. 15 (1976).

Code Section 2032A is a limited departure from the ordinary estate tax valuation rules, which require that property be valued at its fair market value, that is, the price at which the property would change hands between a willing buyer and a willing seller. The maximum reduction in value of qualified real property resulting from an election under Code Section 2032A is $750,000. This maximum amount has been unchanged since 1983.

Another relief provision is Code Section 6166, which permits an executor to elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. When this provision was enacted in 1976, Congress believed that "additional relief should be provided to estates with illiquidity problems arising because a substantial portion of the estate consists of an interest in a closely held business or other illiquid assets." S. Rep. 94-938, 94th Cong., 2d Sess. 18 (1976).

Under Code Section 6166, for the first five years, only interest is required to be paid; payment of the principal may be deferred for five years. To qualify for the election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. Under Code Section 6601(j), a special four-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. This $1,000,000 cap relating to the application of the four-percent interest rate has been unchanged since 1976.

Thus, farmers, ranchers and small businesses can obtain relief from the special use valuation and Code Section 6166 deferral over and above the regular estate-tax exemptions. For example, if a farmer who qulaifies for the full special use valuation election and Code Section 6166 died with a gross estate valued at $1.5 million, the present value of the estate tax due would be approximately $22,890 (taking into account the value of the deferral of payment). In contrast, the estate of an employed person who had accumulated or inherited wealth of $1.5 million would owe an estate tax of approximately $341,500. The effective estate tax rate on the farmer's estate would be under 1.6 percent, while the effective tax rate on the wage-earner's estate would be 23.6 percent.

H.R. 1215

The House-passed tax legislation, H.R. 1215, would increase the amount of the unified credit against gift and estate tax. The increase would exempt the first $700,000 for decedents dying (and gifts made) in 1996; $725,000 in 1997; and $750,000 in 1998. After 1998, the unified credit would be indexed for inflation. The bill would also index for inflation the $10,000 annual exclusion amount, the $1,000,000 GST tax exemption, the $750,000 special use valuation limitation under Code Section 2032A and the $1,000,000 cap on the four-percent interest rate under Code Section 6601. The indexed annual exclusion amount would be rounded to the nearest $1,000; all other indexed amounts would be rounded to the nearest $10,000.

This proposal, if enacted, would reduce tax receipts by $6.7 billion over the five-year FY1996 - FY2000 period, and by $22.6 billion over the ten-year FY1996 - FY2005 period.

Discussion

The Administration recognizes that the levels of the unified credit and various other estate and gift tax limitations have not been increased since 1987. We are willing to work with Congress to maintain an estate and gift tax system that exempts small- and moderate-sized estates, and that helps keep intact small and family businesses, so that they can be passed on to future generations.

In addition to considering the proposal contained in H.R. 1215, we believe that it is appropriate to consider other, more targeted modifications to the estate and gift tax system that might provide appropriate relief to small family businesses. For instance, this Administration previously has testified in support of a proposal, similar to S. 105, that would modify, on a prospective basis, the special valuation rules of Code Section 2032A to allow a qualified heir to cash-lease specially valued real property to certain family members of the decedent, who

continue to operate the farm or closely held business, without triggering a recapture of special valuation benefits.

Only a small number of the wealthiest taxpayers would benefit from the increase in the unified credit in H.R. 1215. In 1989, for example, 2,150,000 taxpayers died. Less than 25,000 of those decedents had taxable estates in excess of $600,000. Thus, with the unified credit provided by current law, the estates of only one percent of decedents paid estate tax in 1989. If the unified credit had been $750,000 rather than $600,000 in 1989, half of those estates would have paid no tax.

Increasing the unified credit is costly and would benefit not only small businesses, but also the very wealthy. We are willing to work with the Congress to achieve a more targeted way to assist small businesses on a revenue-neutral basis.

3. Increase of Expensing Limit for Small Business

Current Law

The cost of business or income-producing property that provides service for more than one year generally must be deducted over the recovery period of the property. Under Code Section 179, a taxpayer may elect, however, to deduct currently up to $17,500 of the cost of the property (i.e., "expense" the property). This $17,500 maximum, however, is reduced for each dollar of the total cost of qualified property acquired during the year in excess of $200,000. Thus, if the cost of qualified property placed in service during the year exceeds $217,500, no expensing is allowed.

H.R. 1215

The House-passed bill, H.R. 1215, would increase the maximum investment that may be expensed to $22,500 for 1996, $27,500 for 1997, $32,500 for 1998, and $35,000 for 1999 and thereafter.

The proposal, if enacted, would reduce tax receipts by $8.0 billion over the five-year FY1996 - FY2000 period, and by $12.5 billion over the ten-year FY1996 - FY2005 period.

Discussion

The Administration supports increasing, on a revenue-neutral basis, the maximum investment that may be expensed for small business. The Administration believes that it is important to encourage small businesses to invest in capital assets. In addition, increasing the maximum expensing deduction would simplify tax reporting for eligible small businesses.

OBRA 93 increased the maximum investment that may be currently deducted from $10,000 to $17,500. At that time, the Administration supported the House version of OBRA 93, which would have raised the maximum to $25,000. The Administration also testified in support of the original House legislation, H.R. 9, reflecting tax provisions of the Contract with America, which would have raised the maximum to $25,000.

The phased-in increase to $35,000, as contained in H.R. 1215, is substantially more expensive than increasing the limit to $25,000, which is estimated to lose $4.2 billion over 5 years and $5.0 billion over 10 years. In this period of budgetary constraints, we would be willing to work with Congress to develop an appropriate revenue offset and would be willing to evaluate whether, in light of these budgetary constraints, the phased-in increase to $35,000 is likely to best meet the needs of small businesses in a cost-effective manner.

DEPARTMENT OF THE TREASURY

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For Release Upon Delivery
Expected at 10:00 a.m.
June 7, 1995

ORAL TESTIMONY OF LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE

Mr. Chairman and Members of the Committee:

I have a longer statement for the record and I'd like to summarize it if I may.

Mr. Chairman, at the outset, I want to congratulate you for calling this hearing. Frustration with our tax system is unacceptably high. We are committed to working with Congress to address this serious problem. An excellent way to improve our tax system is to consider alternatives. Thus, I am pleased to discuss today proposals for fundamental tax reform.

Several plans have been introduced that would replace all or part of the income tax and payroll taxes with a tax on consumption. These reform proposals originate in part from frustration with the complexity of our existing tax system and concerns about our national savings rate.

The most important reason to consider replacing the income tax with a consumption tax is that the change could increase saving and capital formation, and thereby raise our standard of living in the long run. Depending on how it is designed, a consumption tax could also improve economic efficiency and simplify the tax system.

Proponents of consumption taxes argue that a consumption tax would be an effective way to encourage saving. They also suggest that a consumption tax would improve economic efficiency and simplify the tax system. Most of our major trading partners rely more heavily than the United States on consumption taxes, particularly value-added taxes.

Regardless of how they are collected, consumption taxes have one element in common--they tax income only when it is spent on consumer goods and services, or, in order words, they exempt income from new saving from tax.

The proposals that are currently under discussion include Representative Armey's and Senator Specter's plans to adopt a two-part flat rate consumption tax in place of the current corporate and personal income taxes. Representative Gibbons has proposed a

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RR-352

subtraction method VAT in place of the corporate income tax, the payroll tax, and most of the individual income tax. Senators Nunn and Domenici propose to replace the individual and corporate income taxes with two consumption taxes: a flat-rate tax on businesses and a progressive rate individual consumed income tax. In addition, Chairman Archer would replace the present income tax system with a national retail sales tax or a VAT.

Criteria for evaluating consumption tax plans

As with all tax proposals, these reform ideas should be carefully evaluated according to their ability to achieve fundamental tax policy objectives--fairness, efficiency, and simplicity.

Reforms should also include rules to reduce windfall gains and unexpected losses during the period of transition to a new system. Consumption tax proposals, in particular, may require special transition rules to prevent taxing consumption from previously taxed income, which could impose severe tax burdens on elderly Americans. In this regard, I would note that when many economists talk about an ideal consumption tax they postulate that in order to obtain maximum efficiency all existing wealth would be taxed as part of a transition to a new system.

Also, it is widely acknowledged that consumption tax proposals will need special rules for certain sectors, such as financial services businesses. Another issue in considering a Federal-level consumption taxes is coordination with State and local governments, which depend heavily on retail sales taxes for revenues.

The current Federal income tax promotes widely-held social and economic goals, such as home ownership, private charitable giving, and the provision of medical insurance by employers. We expect that a new consumption tax would still promote social and economic goals. But continued use of the tax system for these purposes would greatly lessen the possibilities for simplification and tax rate reduction from replacing our current income tax with a broad-based consumption tax.

Moving from one tax system to another would be complex and costly and would create both intended and unintended winners and losers. It would also change asset values, and the level of prices and wages.

Mr. Chairman, we recognize that the current U.S. income tax system has many defects, and we welcome discussion on how to reform it. But radical changes to the tax system involve major costs and risks. Replacing the entire income tax with a consumption tax would be a grand experiment of applying theory to a practical application that no other country in the world has chosen to undertake. Proponents of these plans must, therefore, overcome a significant hurdle--they must show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

I will comment briefly on four issues: distributional effects, effects on saving, costs of compliance and administration, and the treatment of existing wealth in implementing a change to a consumption tax.

Distributional effects of replacing the income tax with a consumption tax

A consumption tax would typically place a higher burden on low- and middle-income families than an income tax with the same rate structure. In this regard, eliminating the tax on income from new capital benefits high-income families because they receive the bulk of capital income.

Chart 1 shows the distributional effect of replacing the revenue of the corporate and personal income taxes (including the earned income tax credit) with a broad-based consumption tax with no exemptions and a revenue-neutral flat rate of 14.5 percent. This baseline proposal is the simplest and most regressive form of consumption tax. It would increase Federal taxes for families in the first four income quintiles and cut taxes for families in the highest income quintile. Expressed as a percentage of after-tax income under current law, a conversion to a broad-based consumption tax would reduce aggregate after-tax income of the groups of families in the first four quintiles by 3.9 percent to 11.1 percent and increase aggregate after-tax income for families in the highest-income quintile by 5.4 percent.

There are, of course, a number of ways to make consumption taxes less regressive or even progressive. European countries reduce the regressivity of value added taxes by exempting specific goods and services or taxing them at a lower rate. This approach does not make the VAT much less regressive, however, because tax relief from exempting specific goods and services is not directly targeted to low-income families.

Consumption taxes that are collected wholly or in part from individuals can more easily be made progressive than those collected solely from businesses. This can be achieved by providing standard deductions for low income families or graduated rates.

Chart 2 illustrates the effect of including standard deductions and personal exemptions in a general consumption tax. It shows the distributional effect of replacing the individual and corporate income tax with a modified flat tax. With standard deductions of $24,700 for joint returns and $12,350 for single returns and a $5,000 personal exemption, the revenue-neutral flat rate is 22.9 percent.

Under this version of the flat tax, the aggregate after-tax income for the top income quintile would still be 1.6 percent higher than under current law (a net tax cut) and the aggregate after-tax income for the group of families in the first four income quintiles would still be 1.0 to 2.2 percent lower than under current law (a net tax increase).

Chart 3 compares the progressivity of the current Federal tax system with the modified flat tax I just described. It shows that current law is progressive--effective tax rates rise with each income quintile. The modified flat tax is progressive through the fourth income quintile. However, the flat tax proposal ceases to be progressive for families with the very highest incomes. For example, the effective tax rate decreases from 21.7 percent for families in the fourth income quintile to 16.4 percent for families in the top one percent of the income distribution. Compared to present law, the effective tax rate decreases from 24.5 percent to 16.4 percent for families in the top one percent of the income distribution. This decrease in the tax burden occurs because under the flat tax proposal income from new saving and investment is not taxed.

Addressing regressivity is a key challenge in designing a consumption tax that will not add to the tax burdens of lower- and middle-income families. Thus, in analyzing any of the proposals, this is the first question to be asked--is it fair? Compared to the current system, who will be the winners and losers?

Effects on the rate of saving

A consumption tax would not tax the return to new saving and investment. An income tax does tax this return, and thereby discourages saving and investment to some degree. Consequently, one might expect that replacing the income tax with a consumption tax would encourage domestic saving and capital formation.

The national saving rate in the United States has declined in the 1980s compared to the previous three decades, due to a decline in private saving and increases in the Federal budget deficit. We consider the low rate of U.S. saving to be a very serious concern. But we must ask ourselves how much the proposals under public discussion would help. The decline in saving does not appear directly related to changes in tax policy. Marginal tax rates were lowered substantially during the 1980s and new saving incentives were introduced, but the overall rate of private saving still fell.

How much would substituting a consumption tax for the income tax boost total private saving? If the after-tax rate of return on savings goes up, individuals may increase saving for future consumption. Most statistical research by economists, however, finds that the effect of increasing the rate of return on saving is small or negligible.

Our current income tax includes incentives for employers to provide retirement saving plans for all their employees--including low-income employees. The incentives for employers to establish retirement plans would be weaker under a consumption tax.

Simplification of the tax system

Simplification of the tax system is a very important goal of many tax reform proposals. We strongly support this goal. A simpler tax system would lower compliance costs for taxpayers and administration costs for the government.

One source of complexity in our current income tax, the measurement of capital income, would be largely absent under a consumption tax. Three others important sources of complexity--provisions to distribute the tax burden equitably, rules to measure the consumption component of business income properly, and provisions that use the tax system to advance certain social and economic policies, would continue under any consumption tax.

For example, suppose it is desirable to have a consumption tax that continues to promote home-ownership. Because consumption taxes, unlike the income tax, would exempt interest income from tax, continuing to allow a deduction for mortgage interest paid would encourage homeowners to incur additional borrowing beyond their financing needs. Rules to prevent this type of tax arbitrage would be complex and difficult to enforce.

Some commentators have suggested that a switch from the present income tax to a simpler consumption tax would promote compliance from the underground economy. This benefit may easily be overstated. The reporting of income and sales from illegal activities is unlikely to be affected by changes in the tax system. Incentives for not reporting income or sales from "informal" activities would also remain under a consumption tax.

Effect on the balance of trade

Also, it is sometimes argued that, because indirect taxes can be imposed on imports and refunded on exports, the adoption of a VAT or other indirect consumption tax to replace part or all of our current income taxes would encourage U.S. exports. However, trade economists generally agree that such a tax change would not permanently improve either U.S. exports or the U.S. trade balance.

Taxation of existing wealth

A very significant issue in converting to a consumption tax system is deciding how to treat the return to wealth that was accumulated out of after-tax income under the income tax.

For example, without a transition rule for past savings, a retiree who accumulated $100,000 in a savings account out of after-tax income before the imposition of a consumption tax would be taxed on withdrawals from that account that are for consumption.

An exemption for existing wealth may be desirable to relieve the tax burden on individuals with accumulated savings, may of whom are elderly. However, it would also require higher tax rates on wage income and reduce much of the gain in economic efficiency that are predicted from a consumption tax. In this respect, transition rules are not merely an inconsequential technical issue. How existing wealth is treated during the transition could have material economic effects.

Conclusion

We are not at this time convinced that the case for completely replacing the income tax with a consumption tax is compelling. The most frequently cited economic benefit of such a change, an increase in private saving, is uncertain and could be small. Savings incentives within the existing income tax can increase saving without replacing the entire tax system.

The fairness of replacing the income tax with a consumption tax is also a concern. Moving to a flat-rate consumption tax would increase the tax burden on low-income families and lower the tax burden on high-income families. Efforts to improve the progressivity of consumption tax proposals result in complexity. In addition, the effect of switching to a consumption tax on wage and price levels, interest rates, and the value of existing assets--including homes--is uncertain.

In examining consumption tax proposals, it is inappropriate to compare a theoretically ideal consumption tax and the income tax system in place today. Instead, we should analyze a consumption tax that is likely to emerge from the political process. Exclusions would be made under a consumption tax--either for administrative reasons or to support social and economic goals--and those exclusions would reduce the economic benefits of the proposals and increase complexity.

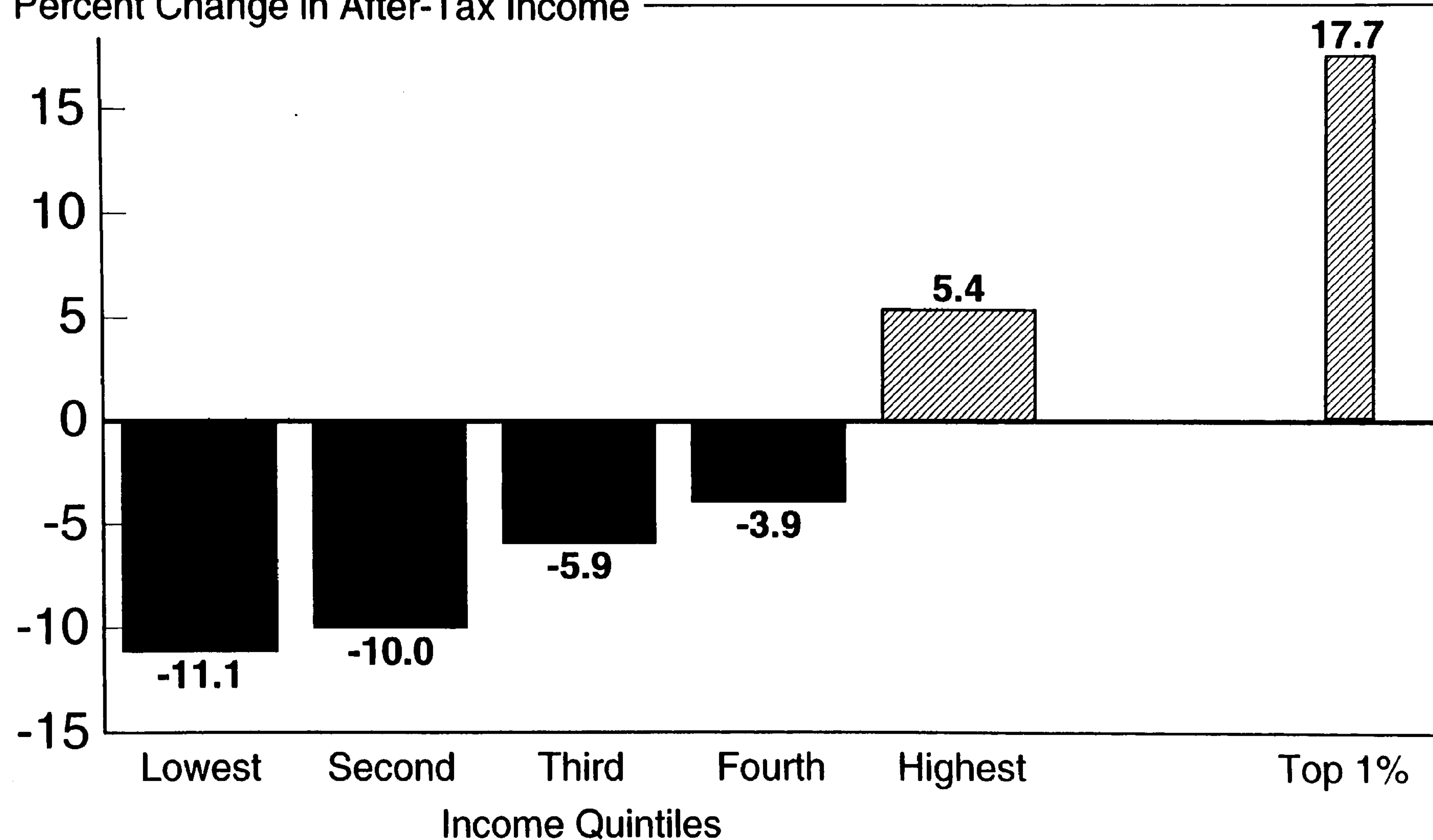
We commend efforts to develop consumption tax proposals that are progressive and revenue-neutral. We are concerned, however, that such a consumption tax could be excessively complex.

Mr. Chairman, we look forward to working with the Congress on improving our tax system. We believe that greater weight should be given to simplification in evaluating tax reform proposals than has been given in the past. A simpler tax system would lower compliance costs for taxpayers and administration costs for the government. We will give serious consideration to proposals that would meet the tax policy objectives set forth in my testimony--proposals that would simplify the tax system and improve economic incentives without sacrificing revenue or fairness.

Moreover, while the debate is in process, simplification should be given greater weight in evaluating changes to our existing tax system. Finally, last year the House of Representatives passed HR 3419, the Simplification and Technical Corrections Act of 1994. We urge the Committee to consider this legislation again.

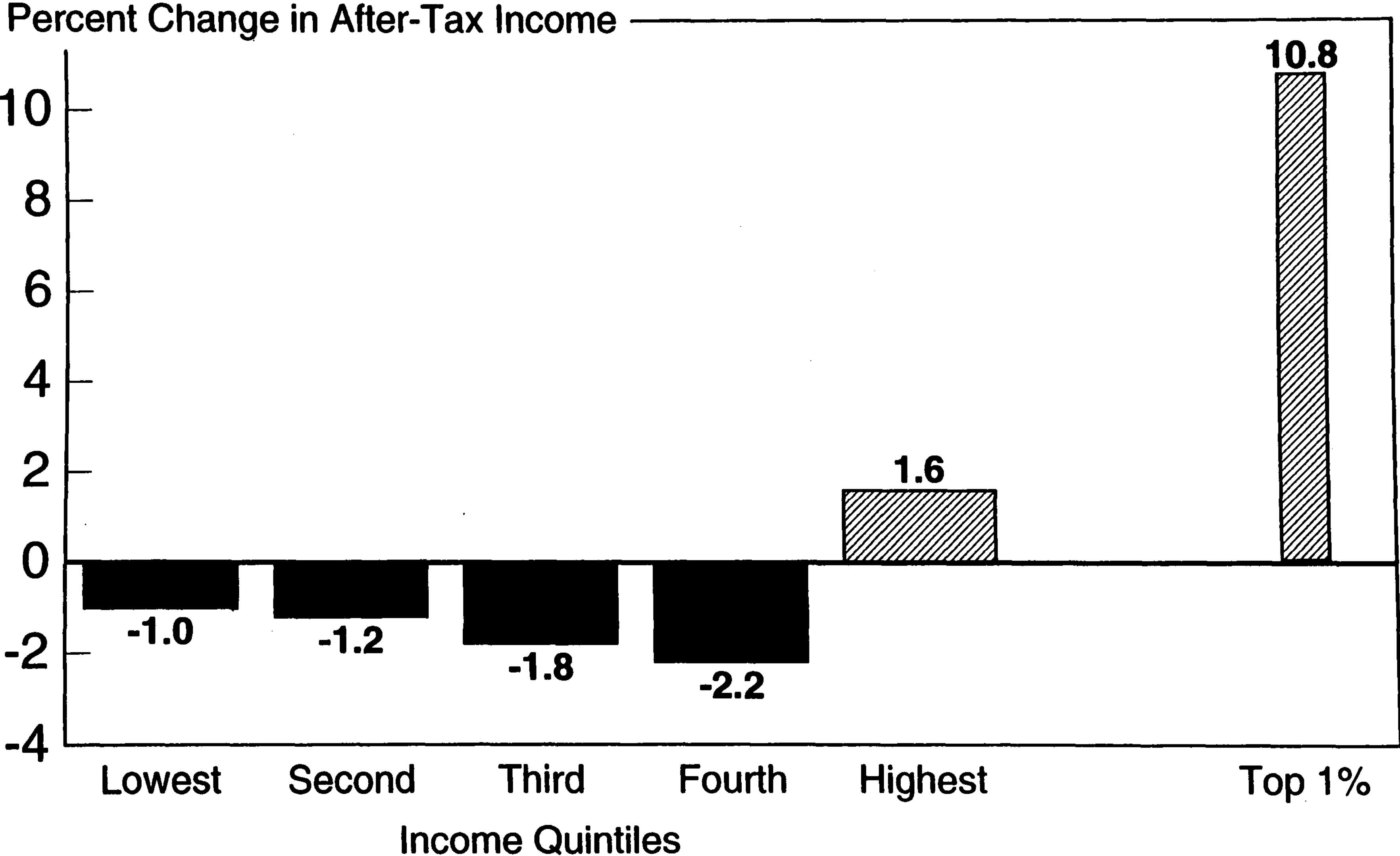
Mr. Chairman, I would be pleased to answer any questions you or members of the Committee may have.

Chart 1: Distributional Effect of Replacing Current Income Taxes with a 14.5% Flat Rate Consumption Tax



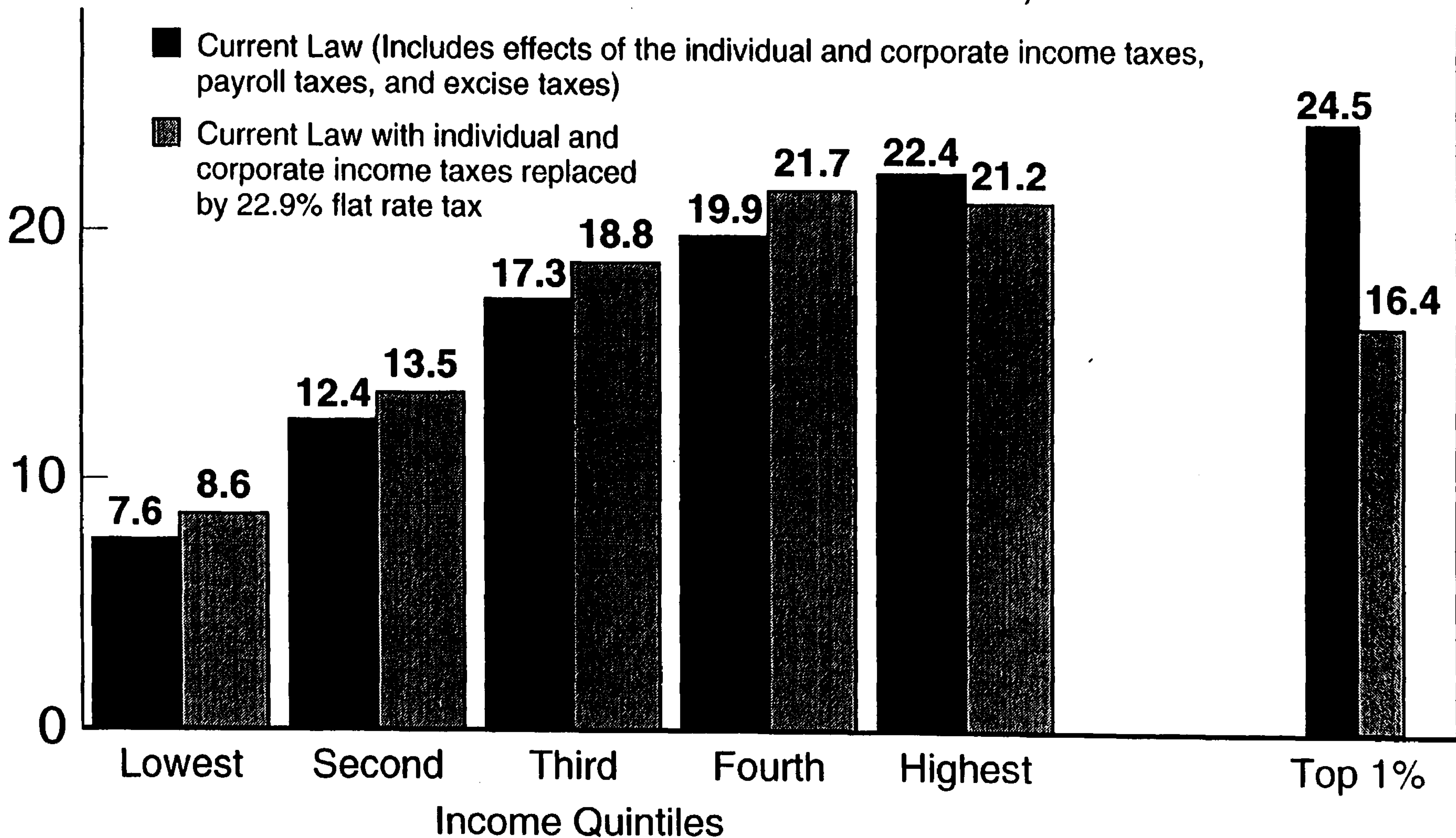
Source: Department of the Treasury (see Table 1 for details)

Chart 2: Distributional Effect of Replacing Current Income Taxes with a 22.9% (Modified) Flat Rate Consumption Tax



Source: Department of the Treasury (see Table 2 for details)

Chart 3: Distributional Effect of Federal Tax System Under Current Law and With Income Taxes Replaced by a 22.9% (Modified) Flat Rate ConsumptionTax



Source: Department of the Treasury

Table 1
Replace Current Individual and Corporate Income Taxes (Including the EITC) with a 14.5% Flat Rate Consumption Tax with No Exemptions(1)

(1996 Income Levels)

Family Economic Income Quintile (2)	After-Tax (3) Income Under Current Law ($B)	Change in After-Tax Income from Proposal (4): Repeal Income Tax ($B)	Flat Rate Consumption Tax with No Exemptions ($B)	Total Change: Amount ($B)	Total Change: Percentage Change (%)	Percentage Change In Total Federal Taxes (%)
Lowest (5)	171.1	-4.5	-14.5	-19.0	-11.1	134.1
Second	431.0	9.9	-53.1	-43.2	-10.0	70.5
Third	697.9	59.6	-100.6	-40.9	-5.9	27.9
Fourth	1,091.9	126.6	-168.8	-42.2	-3.9	15.5
Highest	2,693.1	536.7	-391.4	145.4	5.4	-18.6
Total (5)	5,054.7	729.4	-729.4	0.0	0.0	0.0
Top 10%	1,899.8	427.7	-264.9	162.8	8.6	-28.8
Top 5%	1,371.5	341.2	-180.5	160.7	11.7	-38.7
Top 1%	683.5	202.7	-81.5	121.2	17.7	-54.6

Department of the Treasury
Office of Tax Analysis

March 7, 1995

(1) This table distributes the estimated change in after-tax income due to the proposal with a revenue-neutral rate of 14.5 percent.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The portion of the flat rate consumption tax that falls on wages, fringe benefits, and pension benefits is assumed to be borne proportionately by wages, fringe benefits, and pension benefits. The remaining portion of the flat rate consumption tax, which falls on business cash flow, is assumed to be borne by capital income generally.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,438.

Table 2
Replace Current Individual and Corporate Income Taxes with a 22.9% (Modified) Flat Rate Tax (1)

(1996 Income Levels)

Family Economic Income Quintile (2)	After-Tax (3) Income Under Current Law ($B)	Change in After-Tax Income Under Proposal (4): Repeal Income Tax (except EITC) ($B)	22.9% Tax on Wages Over Stand. Ded. (5) ($B)	22.9% Tax on Fringes and Payroll Tax (6) ($B)	22.9% Tax on Business Cash Flow ($B)	Total Change ($B)	Percentage Change (%)	Percentage Change In Total Federal Taxes (%)
Lowest (7)	171.1	3.8	-0.9	-2.7	-1.9	-1.7	-1.0	12.2
Second	431.0	25.0	-11.8	-9.0	-9.5	-5.2	-1.2	8.5
Third	697.9	64.1	-38.7	-17.0	-20.7	-12.2	-1.8	8.3
Fourth	1,091.9	127.6	-91.5	-26.5	-33.8	-24.2	-2.2	8.9
Highest	2,693.1	537.0	-300.1	-39.5	-154.1	43.3	1.6	-5.6
Total (7)	5,054.7	758.6	-443.7	-94.9	-220.0	0.0	0.0	0.0
Top 10%	1,899.8	427.9	-211.0	-21.0	-128.8	67.0	3.5	-11.9
Top 5%	1,371.5	341.2	-142.2	-10.6	-108.6	79.7	5.8	-19.2
Top 1%	683.5	202.7	-58.5	-2.3	-68.3	73.7	10.8	-33.2

Department of the Treasury / Office of Tax Analysis March 7, 1995

(1) This table distributes the estimated change in after-tax income due to the proposal with a revenue-neutral rate of 22.9 percent (approximately).

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The flat tax on wages (plus pension benefits received) is assumed to be borne by wages plus pension benefits received in excess of the standard deduction. The flat tax on employer-provided fringe benefits (except pension contributions) and payroll taxes is assumed to be borne by employees in proportion to benefits or taxes. The flat tax on business cash flow is assumed to be borne by capital income generally.

(5) The standard deduction (in 1995$) is $24,700 (joint) or $12,350 (single) plus $5,000 for each dependent. Non-pension fringe benefits of government and nonprofit employees are included in wages.

(6) The proposal would disallow a deduction for employer-provided fringe benefits (except pension contributions) making these benefits (primarily employer-provided health insurance) subject to the 22.9 percent flat tax. The employer portion of payroll taxes would likewise be nondeductible.

(7) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,438.

Table 3
Replace Current Individual and Corporate Income Taxes with a 22.9% (Modified) Flat Rate Tax (1)

(1996 Income Levels)

Family Economic Income Quintile (2)	Federal Taxes Under Current Law (3) ($B)	Federal Taxes with 22.9% Flat Rate Tax (4) ($B)	Change in Federal Taxes ($B)	Taxes as a Percent of Pre-Tax Income Under: Current Law (%)	Taxes as a Percent of Pre-Tax Income Under: with 22.9% Flat Rate Tax (%)
Lowest (7)	14.2	15.9	1.7	7.6	8.6
Second	61.2	66.4	5.2	12.4	13.5
Third	146.5	158.7	12.2	17.3	18.8
Fourth	271.8	296.0	24.2	19.9	21.7
Highest	779.5	736.2	-43.3	22.4	21.2
Total (7)	1275.1	1275.1	0.0	20.1	20.1
Top 10%	565.3	498.3	-67.0	22.9	20.2
Top 5%	415.3	335.6	-79.7	23.2	18.8
Top 1%	221.9	148.3	-73.7	24.5	16.4

Department of the Treasury
Office of Tax Analysis

June 5, 1995

(1) This table distributes the estimated change in Federal taxes due to a (modified) flat rate tax with a revenue-neutral rate of 22.9 percent (approximately) which replaces the current individual and corporate income taxes.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The flat tax on wages (plus pension benefits received) is assumed to be borne by wages plus pension benefits received in excess of the standard deduction. The flat tax on employer-provided fringe benefits (except pension contributions) and payroll taxes is assumed to be borne by employees in proportion to benefits or taxes. The flat tax on business cash flow is assumed to be borne by capital income generally.
The standard deduction (in 1995$) is $24,700 (joint) or $12,350 (single) plus $5,000 for each dependent. Non-pension fringe benefits of government and nonprofit employees are included in wages.
The proposal would disallow a deduction for employer-provided fringe benefits (except pension contributions) making these benefits (primarily employer-provided health insurance) subject to the 22.9 percent flat tax. The employer portion of payroll taxes would likewise be nondeductible.

(5) Families with negative incomes are included in the total line but not shown separately.

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RECORD TESTIMONY OF LESLIE B. SAMUELS
ASSISTANT SECRETARY FOR TAX POLICY
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

RR-353

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Table of Contents

page number

Introduction 1

Background 2
- What is a consumption tax? 3
- Options for taxing consumption 4
  1. Retail sales tax 5
  2. Value-added tax 5
  3. Two-part individual/business consumption tax 5
  4. Consumed income tax 6

Distributional effects of replacing the income tax with a consumption tax . . . 6
- Replacing the income tax with a flat-rate consumption tax 6
- Addressing the regressivity of a consumption tax 10

Economic effects of replacing the income tax with a consumption tax 17
- Saving and investment 17
  1. National saving 17
  2. Tax policy and private saving 20
  3. Saving and investment 21
  4. Interest rates 22

- Prices and wages 22
- Asset values 23
- Economic efficiency 24
  1. Allocation of capital 24
  2. Taxation of existing wealth 25
  3. Labor supply 25
  4. Consumption-saving choice 26

- International trade 26
- Sector-specific issues of adopting a consumption tax 28

Simplicity 29
- Distribution of the tax burden 31
- Measuring consumption 31
- Promoting social and economic goals 32

The underground economy 32

Coordination with State and local taxes 33

Transition to a consumption tax and the tax on existing wealth 33

Conclusion 35

Mr. Chairman and Members of the Committee:

Introduction

I am pleased to discuss today proposals for fundamental reform of the tax system. During the last two years, several proposals have been made that would replace all or part of the income tax and payroll taxes with a tax on consumption. The conceptual proposals under current discussion include Representative Armey's and Senator Specter's plans to adopt a two-part flat consumption tax in place of the current corporate and personal income taxes, Representative Gibbons' plan to adopt a subtraction method value-added tax (VAT) in place of the corporate income tax, the payroll tax, and most of the individual income tax, and a plan by Senators Nunn and Domenici to replace the individual and corporate income taxes with two consumption taxes: a flat-rate tax on businesses and a progressive-rate individual consumed income tax. In addition, Chairman Archer would replace the present income tax system with a national retail sales tax or a VAT. Some of these proposals have been introduced as bills, but we understand that some of them are not yet in final form.

The interest in consumption taxes apparently arises for several reasons. The most frequently cited benefit of moving from a system that taxes income toward one that taxes consumption is that a consumption tax will improve saving rates and capital formation, and our standard of living in the long run. Proponents of consumption taxes also argue that a consumption tax would improve economic efficiency -- and thereby increase national output -- and simplify the tax system. Some supporters of consumption taxes point out that most of our major trading partners rely more heavily on consumption taxes, particularly VATs, and that adoption of a VAT in the United States would be more compatible with international practices.

Mr. Chairman, we recognize that the current U.S. income tax system has many defects, and we welcome the discussion on how to reform it. Since radical changes to the tax system -- especially changes that would completely replace the existing system -- involve costs and risks, they should be carefully evaluated according to their ability to achieve the fundamental objectives of a tax system -- fairness, efficiency, and simplicity. We believe a tax system should:

- raise sufficient revenue,
- distribute the burden of taxes equitably,
- avoid excessive intrusion of tax considerations into private economic decisions,
- promote economic prosperity and growth,
- and limit the costs to families and businesses of complying with the tax and the costs to the government of administering it.

Reforms should also include rules to reduce windfall gains and losses during the period of transition to a new system. Consumption tax proposals, in particular, should address the effect of the transition on the tax burden of the elderly, should include rules for the treatment of certain hard-to-tax economic sectors, such as financial institutions, and should address the coordination of a Federal consumption tax with State and local retail sales taxes.

In addition to these general tax policy objectives, the Federal income tax has, over the years, been used to promote widely-held social and economic goals, such as home ownership, private charitable giving, and provision of medical insurance by employers. It is likely that these goals would continue to be seen as pursuits worthy of preference under a reformed tax system. To the extent that a reformed system is to be used to promote social and economic goals, possibilities for simplification and tax rate reduction would be materially reduced.

The strongest argument for a consumption tax is that it will probably increase saving and investment, but the amount of any increase is highly uncertain and could be small. Other ways of increasing national saving -- such as further deficit reduction or expanding saving incentives within the income tax -- can be used to further this objective either more surely or with less overall disruption than a wholesale replacement of the existing income tax.

Replacing the income tax with a consumption tax also raises concerns about fairness, because many consumption tax alternatives would increase the tax burden on low- and middle-income families. Efforts to improve the progressivity of consumption taxes would require significant increases in costs of compliance and administration. Moving from one tax system to another would also be complex and costly and would create both intended and unintended winners and losers. It also would change asset values, and the level of prices and wages.

Replacing the entire income tax with a consumption tax would be a grand experiment of applying theory to a practical application that no other country in the world has chosen to undertake. Proponents of these plans must, therefore, overcome a significant hurdle -- they must show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

The remainder of my testimony will describe (i) various types of consumption taxes, (ii) the distributional and economic effects of replacing the income tax with a consumption tax (including the international aspects of the proposals), (iii) some issues related to specific economic sectors that would have to be addressed in implementing a consumption tax, (iv) observations about simplifying the tax system, (v) the effect of some consumption tax proposals on the underground economy, (vi) coordination of proposals with State and local retail sales taxes, and (vii) transition issues.

Background

Imposing taxes on the basis of income (whether from labor or the return to savings and investment) arises from the principle that an equitable tax system should take into consideration the variation among individuals' ability to pay taxes. The "ability-to-pay" principle is often understood to mean that a tax should be progressive with respect to income; that is, the portion of income that is paid in taxes should rise as income rises. A broad-

based income tax with graduated tax rates, as in the United States and other advanced economies, satisfies that criterion. An income tax need not have graduated rates, however. A flat-rate income tax applied beyond some base level of income would be progressive, but not to the same degree as a graduated-rate tax.

What is a consumption tax?

As an alternative to income-based taxes, consumption taxes are levied only on income that is spent on consumer goods and services; or, in other words, income that is saved is exempt from tax. Within this definition, broad-based consumption taxes can be administered in a number of ways. They can be collected wholly from businesses, either on final sales to consumers or on the value-added by all businesses at each stage of production. They can be collected in part from businesses and in part from wage-earners by allowing businesses to deduct wages and taxing them at the individual level. They can be collected wholly from individuals by modifying the current individual income tax to allow taxpayers to claim a deduction for all net saving. Furthermore, the statutory rates under a consumption tax can be flat, or they can differ across individuals or across different types of consumption. And a consumption tax that is collected from businesses can be broad-based, or it can exempt certain goods and services or businesses from tax.

Consumption taxes that are collected from individuals exempt income that is saved from tax in one of two ways: (1) by allowing a deduction from an income base for income that is saved and adding to the tax base the amount dissaved, or (2) by including compensation in the tax base and exempting the return to savings (interest, dividends, and capital gains). To see how exempting income that is saved is equivalent to exempting the return to savings, consider the effect of each approach on a taxpayer who begins a year with $100 of wage income and wishes to postpone all consumption for five years. The taxpayer saves all of his after-tax wage income in the first year and earns a five percent annual return on his savings. At the end of five years, he withdraws his principal and accumulated interest and spends it. In each year, the tax rate is 28 percent.

In the first case, the taxpayer is allowed a deduction for net saving, but is taxed on net withdrawals from savings. The taxpayer deposits his $100 of wages in a savings account. He deducts $100 from his taxable income, leaving him with zero taxable income and zero tax liability. His after-tax consumption in the first year is also zero. Because the taxpayer reinvests the interest income on his savings, he owes no tax on the interest income during the next five years. In the fifth year he withdraws $127.63: his original savings of $100 plus interest of $27.63. At a tax rate of 28 percent, his tax due on $127.63 of taxable income is $35.74. His after-tax consumption is $91.89.

In the second case, the taxpayer must pay tax on his wage income and receives no savings deduction. He pays $28 of tax on his $100 of wage income and deposits the remaining $72 of after-tax income in the bank. He has zero after-tax consumption in the first year. Over the next five years, his interest income is exempt from tax. In the fifth year

he withdraws $91.89, his original savings of $72 plus interest of $19.89. His taxable income is zero, and his after-tax consumption is $91.89. Assuming that the taxpayer is in the same tax bracket during the five-year period, exempting the return to saving results in the same pattern of after-tax consumption as allowing a deduction for income that is saved, leaving the taxpayer indifferent between the two approaches.

Consumption taxes that are collected from businesses grant an immediate deduction for purchases of new capital stocks (including machinery, buildings, land, and inventory). This immediate deduction -- or "expensing" -- effectively eliminates the tax on the return from new investment. A consumption tax that is collected in part from individuals and in part from businesses would allow businesses to expense capital purchases and, under the individual tax, either exempt income that is saved or exempt the return to savings. The combination of these mechanisms ensures that income from capital -- the return to saving and investment -- is untaxed at any level.

Relieving new saving and new investment from tax is seen as the primary benefit of taxing consumption instead of income. Because the after-tax return to savers will increase, families will have an incentive to save more. But exempting the return to new saving reduces the tax base, requiring higher tax burdens on wage income. Moreover, because low- and middle-income households typically do not save as large a percentage of their incomes as higher-income households, flat rate consumption taxes are regressive -- effective tax rates decline as family incomes rise. Addressing the regressivity problem is a key challenge in designing a consumption tax that will not add to tax burdens of lower- and middle-income families.

While the key feature of a consumption tax is that it exempts income from new saving and investment, it should also be noted that many forms of consumption tax would reduce the number and types of deductions allowed to businesses. In general, a business-level consumption tax will allow deductions only for payments made to other businesses. Therefore, wage payments and the cost of non-pension employee fringe benefits -- such as employer-provided health insurance -- State and local taxes, and payroll taxes would generally not be deductible to businesses. The disallowance of deductions for fringe benefits and for the employer portion of the payroll tax under some proposals represents a "hidden" tax on employees, since most economists believe that these taxes would be shifted by employers to their employees.

Options for taxing consumption

There are a number of ways to administer a consumption tax, although the various forms would all not tax the return from new saving. The distributional effects and administrative costs would depend on the details of each proposal.

The theoretical model for each general option is described below. Applying theory to practice, however, will inevitably involve some compromises with the pure models. The

degree of the deviations will be important in assessing both the possible viability and the overall economic effects of any particular proposal.

1. Retail sales tax (RST). Businesses are the sole collection agents for retail sales taxes -- like those used by most States -- and VATs. A RST is applied to sales of goods and services to households. In order to tax only sales to consumers, the RST must exempt sales between businesses and distinguish between taxable and exempt sales of capital goods. If the RST is levied on a broad base, it is a tax on total consumption. Because a RST is collected only on retail sales to domestic consumers, it automatically taxes imports and exempts exports. State sales taxes in the United States are not broad-based for two main reasons. First, certain purchases, including purchases of housing and necessities like food and medical care, are tax-exempt for social policy reasons. Second, many services are exempt for administrative reasons.

2. Value-added tax. Most countries that have a national consumption tax administer it as a credit-invoice VAT. Under this system, businesses are liable for VAT on their sales, but receive a credit against their tax liabilities for VAT paid on inputs purchased from other businesses. Credit-invoice VATs in effect in other countries tax imports and exempt exports. They achieve this result by not taxing export sales, while allowing exporters a credit for all purchased inputs, and effectively imposing tax on goods purchased from other countries by not allowing their costs to be creditable.

Under a subtraction method VAT (also called a "business transfer tax" or BTT), a business is liable for tax on the difference between its sales and its purchases from other businesses, including purchases of buildings and equipment (but, as stated above, excluding other costs such as taxes paid and labor compensation). If the tax is applied to all goods and services at the same rate, a credit-invoice method VAT is economically equivalent to a similarly broad-based subtraction method VAT or national RST. Under Representative Gibbons' proposal, businesses would be subject to a subtraction method VAT.

3. Two-part individual/business consumption tax. Another form of consumption tax is collected in part from individuals and in part from businesses. The tax could be administered in the same way as a subtraction method VAT, except that it would allow wages to be deducted from the business tax base and would tax them at the individual level. If wages are subject to the same, single tax rate that is applied to businesses, the tax is "flat."

The proposals by Representative Armey and Senator Specter are consumption taxes of this form. In their proposals, wages are subject to a flat tax rate equal to the business tax rate, but wage earners are allowed to claim personal exemptions. These plans are economically equivalent to a VAT with a credit for wages up to the personal exemption amount. Alternatively, the individual portion of the tax could be levied at graduated rates. With no exemptions or deductions, the base of this two-part tax is the same as that of a broad-based VAT or national RST -- total consumption.

4. Consumed income tax. A consumption tax collected solely from individuals would be levied directly on their reported income, just like the current income tax, but would allow a deduction for net saving. The base of this tax is equal to consumption, because consumption is the difference between income and net saving. In order to measure income properly, proceeds from all forms of borrowing would need to be included in the tax base, and all forms of saving would be deductible.

The USA Tax System proposed by Senators Nunn and Domenici is comprised of both a flat-rate tax on businesses that is similar to a subtraction method VAT and a progressive-rate individual consumed income tax. The Nunn-Domenici proposal would not allow a deduction for labor costs under the business tax and would include labor income under the individual tax. This means that wages and salaries and non-pension fringe benefits would be taxed twice: once at the business level and again at the individual level. However, the tax burden on wages would be reduced through tax credits to both employers and employees for payroll taxes paid.

Distributional effects of replacing the income tax with a consumption tax

Replacing the income tax with a flat-rate consumption tax

The effect on the distribution of the tax burden of replacing the income tax with a consumption tax depends on the details of the tax that is adopted and on which taxes are replaced. Generally, however, taxing consumption places a higher burden on low- and middle-income families -- who typically do not save much of their income -- relative to an income tax. Because capital income is concentrated among high-income families, eliminating the tax on income from new capital will disproportionately benefit high-income families.[1] The change will, therefore, shift the tax burden away from high-income families to middle- and low-income families.

Table 1 shows the distributional effect of replacing the revenue of the corporate and personal income taxes (including the earned income tax credit) with a general consumption tax with no exemptions (such as a broad-based VAT or national RST).[2] The revenue-neutral rate of 14.5 percent used for these calculations assumes that the tax is imposed on all consumption in the economy, including consumption services supplied by the government and non-profit sectors, which would probably be exempt from a VAT or RST. In practice,

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[1]For example, about 40 percent of all taxable interest and dividend income reported on 1991 individual tax returns was received by the 6 percent of taxpayers with adjusted gross income over $75,000. See U.S. Internal Revenue Service, Statistics of Income Division, *Individual Income Tax Returns--1991*, U.S. Government Printing Office, 1994, pp. 28-30.

[2]For an explanation of how to design a consumed income tax that is distributionally neutral across income quintiles, see U.S. Congressional Budget Office, *Estimates for a Prototype Saving-Exempt Income Tax*, Congressional Budget Office, 1994, pp. 19-28.

therefore, the rate that would be required under a broad-based VAT or RST would probably be much higher.[3]

At the 14.5 percent tax rate, the aggregate after-tax income for the group of families in the first through fourth income quintiles would be lower under the flat tax (i.e., a net tax increase), while the aggregate after-tax income for the group of families in the highest income quintile would be higher under the flat tax (a net tax cut). Expressed as a percentage of after-tax income under current law, the proposal would cause a reduction in aggregate after-tax income of between 3.9 percent and 11.1 percent for the groups of families in the first through fourth income quintiles and a 5.4 percent increase in after-tax income for the groups of families in the highest income quintile.[4] This amounts to aggregate increases in Federal taxes ranging from 15.5 percent to 134.1 percent for the group of families in the first through fourth income quintiles, and a 18.6 percent reduction in taxes for the group of families in the highest income quintile.[5,6]

In this analysis, the burden of the consumption tax is distributed to taxpayers according to components of current income. But individuals may base current expenditures on their expectation of future income as well as on current income. For example, college students who earn very little while they are in school might, nevertheless, have high current consumption expenditures if they are able to borrow against the expectation that they will have high incomes in the future. In such cases, annual income understates economic well-being. Annual income may overstate economic well-being in a year when a family receives

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[3]The 14.5 percent tax rate would be applied on a tax-inclusive basis, in a manner similar to the income tax. The equivalent rate calculated on a tax-exclusive basis, as would be relevant under a VAT, is 17.0 percent.

[4]These results are illustrated in Chart 1.

[5]The distributional estimates shown in the Table 1 are based on the assumption that the consumption tax is borne by taxpayers in proportion to their earnings and income from existing capital. Alternative assumptions could be made about who bears the burden of the tax. A traditional assumption is that a consumption tax is borne by consumers in proportion to their consumption. We have not followed this approach, because it overstates the tax cut for high-income families and the tax increases for low- and middle-income families by failing to adjust for temporary income fluctuations and normal life-cycle patterns of consumption and income. In addition, lack of reliable data on consumption by families with very high and very low incomes make distributional estimates based on the traditional approach less reliable than those shown in Table 1. Following this approach would lead to a more regressive distribution of the tax than that shown in Table 1.

[6]The finding that replacing the income tax with a flat-rate consumption tax would redistribute tax burdens from low-income to high-income families is consistent with previous analyses. For example, CBO and JCT find that, under a broad-based VAT, low-income families would pay a higher fraction of their income in tax compared to high-income families. See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 32-7, and Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens*, U.S. Government Printing Office, 1993, p. 54-5.

Table 1
Replace Current Individual and Corporate Income Taxes (Including the EITC) with a 14.5% Flat Rate Consumption Tax with No Exemptions(1)

(1996 Income Levels)

Family Economic Income Quintile (2)	After-Tax (3) Income Under Current Law ($B)	Change in After-Tax Income from Proposal (4): Repeal Income Tax ($B)	Flat Rate Consumption Tax with No Exemptions ($B)	Total Change: Amount ($B)	Total Change: Percentage Change (%)	Percentage Change In Total Federal Taxes (%)
Lowest (5)	171.1	-4.5	-14.5	-19.0	-11.1	134.1
Second	431.0	9.9	-53.1	-43.2	-10.0	70.5
Third	697.9	59.6	-100.6	-40.9	-5.9	27.9
Fourth	1,091.9	126.6	-168.8	-42.2	-3.9	15.5
Highest	2,693.1	536.7	-391.4	145.4	5.4	-18.6
Total (5)	5,054.7	729.4	-729.4	0.0	0.0	0.0
Top 10%	1,899.8	427.7	-264.9	162.8	8.6	-28.8
Top 5%	1,371.5	341.2	-180.5	160.7	11.7	-38.7
Top 1%	683.5	202.7	-81.5	121.2	17.7	-54.6

Department of the Treasury
Office of Tax Analysis

March 7, 1995

(1) This table distributes the estimated change in after-tax income due to the proposal with a revenue-neutral rate of 14.5 percent.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

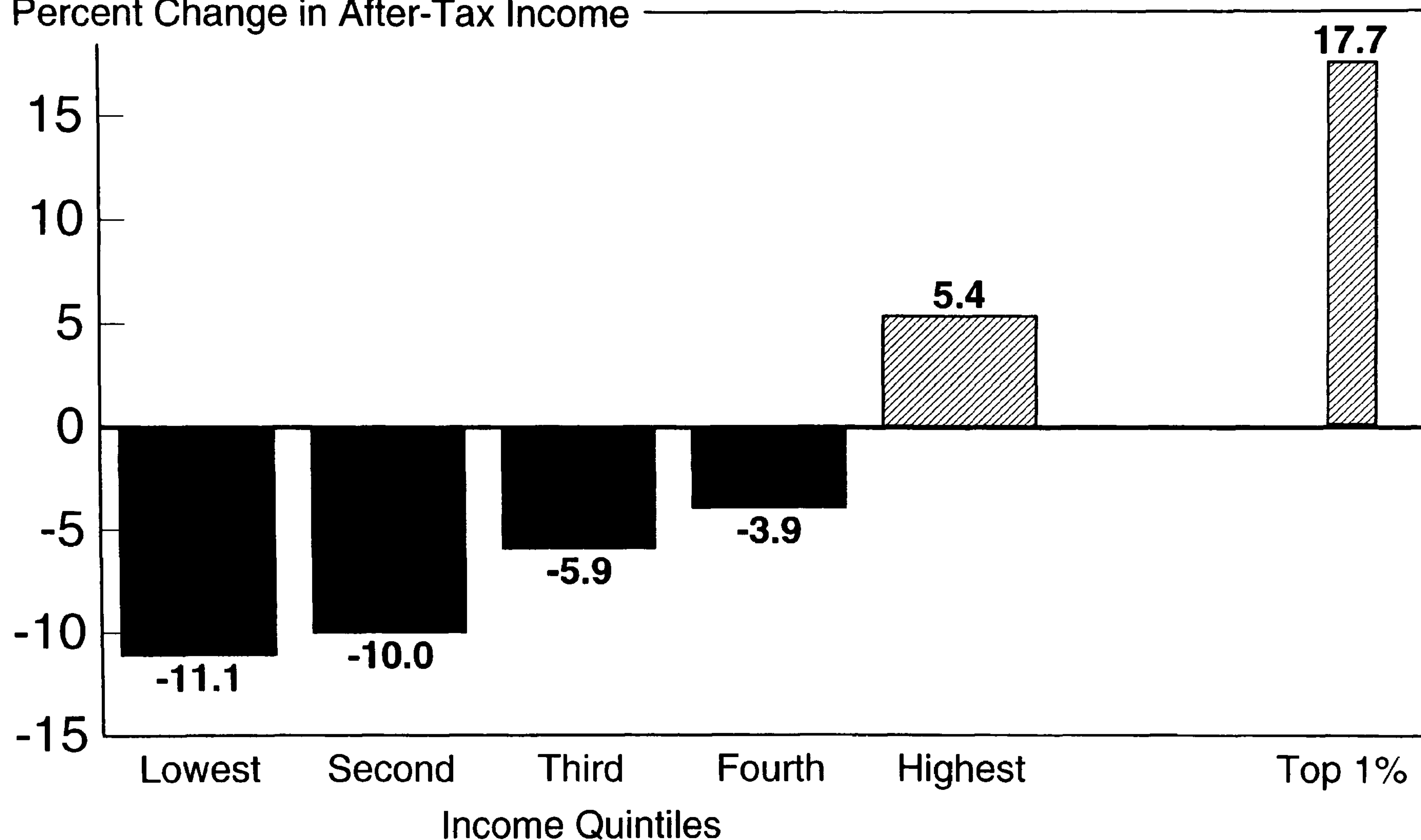
(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The portion of the flat rate consumption tax that falls on wages, fringe benefits, and pension benefits is assumed to be borne proportionately by wages, fringe benefits, and pension benefits. The remaining portion of the flat rate consumption tax, which falls on business cash flow, is assumed to be borne by capital income generally.

(5) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,438.

Chart 1: Distributional Effect of Replacing Current Income Taxes with a 14.5% Flat Rate Consumption Tax



Source: Department of the Treasury (see Table 1 for details)

income from a transitory source, such as a large bonus. For these reasons, some economists argue that lifetime income is a better measure of an individual's long-term economic well-being than annual income. Our analyses, however, do not distribute tax burdens according to lifetime income because future earnings are uncertain, and even if future earnings were known, lifetime income would be difficult to measure with accuracy. In addition, lifetime income is an inappropriate measure of current well-being if individuals are unable to smooth their consumption over their lifetime by borrowing and saving. For example, if the college students mentioned above are not able to borrow against their uncertain future earnings, it may be inappropriate for the tax system to view them as well-off currently.[7] Nevertheless, some studies show that distributing a general consumption tax to families according to their estimated lifetime income makes the tax appear to be less regressive.

Addressing the regressivity of a consumption tax

An important difference among the various forms of consumption taxes lies in the mechanisms available for distributing the tax more equitably among families with different incomes. One way that European countries attempt to reduce the regressivity of the VAT is by exempting specific goods and services from the tax or taxing them at a lower rate. This approach does not reduce regressivity effectively because tax relief from exempting specific goods and services is difficult to target to low-income families. While the tax preference does relieve the burden on low-income families, middle- and upper-income households also benefit when they purchase tax-preferred goods and services, requiring higher rates on other goods and services that low-income families buy to raise the same revenue. Other approaches, such as refundable credits and expansion in government transfer programs are more effective ways to offset regressivity, but would add to administrative and compliance costs and require explicit increases in government outlays.

A consumption tax that is collected at least in part from individuals can better account for differences in ability to pay among families and individuals than one that is collected solely from businesses. Such a tax can be made less regressive through standard deductions, as under Representative Armey's and Senator Specter's flat tax proposals, and/or graduated rates, as under the Nunn-Domenici plan. Refundable credits like the earned income tax credit (EITC) can also be used to reduce the tax burden on low-income families, but credits carry with them administrative costs. For example, low-income families, who otherwise might be excluded from the tax system, would be required to file a return in order to receive the credit.

As an illustration of the effect of including standard deductions and personal exemptions in a general consumption tax, Table 2 shows the distributional effect of replacing the corporate and individual income taxes with a stylized flat tax similar to the Armey

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[7]For a more detailed discussion of these points, see Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens*, U.S. Government Printing Office, 1993, pp. 82-6.

Table 2
Replace Current Individual and Corporate Income Taxes with a 22.9% (Modified) Flat Rate Tax (1)

(1996 Income Levels)

Family Economic Income Quintile (2)	After-Tax (3) Income Under Current Law ($B)	Change in After-Tax Income Under Proposal (4): Repeal Income Tax (except EITC) ($B)	22.9% Tax on Wages Over Stand. Ded. (5) ($B)	22.9% Tax on Fringes and Payroll Tax (6) ($B)	22.9% Tax on Business Cash Flow ($B)	Total Change ($B)	Percentage Change (%)	Percentage Change In Total Federal Taxes (%)
Lowest (7)	171.1	3.8	-0.9	-2.7	-1.9	-1.7	-1.0	12.2
Second	431.0	25.0	-11.8	-9.0	-9.5	-5.2	-1.2	8.5
Third	697.9	64.1	-38.7	-17.0	-20.7	-12.2	-1.8	8.3
Fourth	1,091.9	127.6	-91.5	-26.5	-33.8	-24.2	-2.2	8.9
Highest	2,693.1	537.0	-300.1	-39.5	-154.1	43.3	1.6	-5.6
Total (7)	5,054.7	758.6	-443.7	-94.9	-220.0	0.0	0.0	0.0
Top 10%	1,899.8	427.9	-211.0	-21.0	-128.8	67.0	3.5	-11.9
Top 5%	1,371.5	341.2	-142.2	-10.6	-108.6	79.7	5.8	-19.2
Top 1%	683.5	202.7	-58.5	-2.3	-68.3	73.7	10.8	-33.2

Department of the Treasury / Office of Tax Analysis — March 7, 1995

(1) This table distributes the estimated change in after-tax income due to the proposal with a revenue-neutral rate of 22.9 percent (approximately).

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The flat tax on wages (plus pension benefits received) is assumed to be borne by wages plus pension benefits received in excess of the standard deduction. The flat tax on employer-provided fringe benefits (except pension contributions) and payroll taxes is assumed to be borne by employees in proportion to benefits or taxes. The flat tax on business cash flow is assumed to be borne by capital income generally.

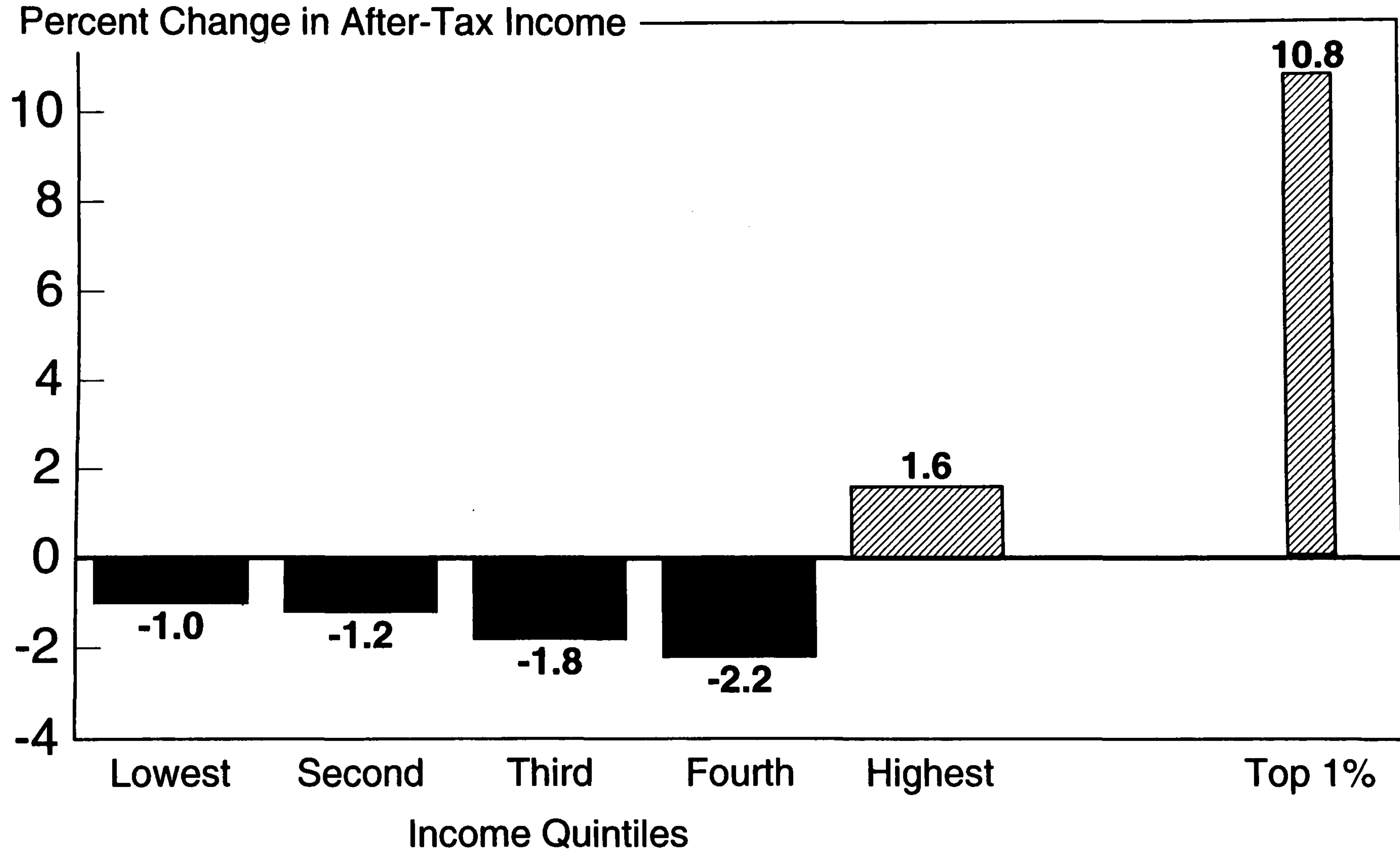
(5) The standard deduction (in 1995$) is $24,700 (joint) or $12,350 (single) plus $5,000 for each dependent. Non-pension fringe benefits of government and nonprofit employees are included in wages.

(6) The proposal would disallow a deduction for employer-provided fringe benefits (except pension contributions) making these benefits (primarily employer-provided health insurance) subject to the 22.9 percent flat tax. The employer portion of payroll taxes would likewise be nondeductible.

(7) Families with negative incomes are excluded from the lowest quintile but included in the total line.

NOTE: Quintiles begin at FEI of: Second $15,604; Third $29,717; Fourth $48,660; Highest $79,056; Top 10% $108,704; Top 5% $145,412; Top 1% $349,436

Chart 2: Distributional Effect of Replacing Current Income Taxes with a 22.9% (Modified) Flat Rate Consumption Tax



Source: Department of the Treasury (see Table 2 for details)

proposal.[8] With standard deductions of $24,700 (for joint returns) or $12,350 (for single-filers) and a $5,000 exemption for each dependent, the revenue-neutral rate for the flat tax rises to 22.9 percent. Under this version of the flat tax, the aggregate after-tax income for the group of families in the first through fourth income quintiles would still be lower than under current law (i.e., a net tax increase), while the aggregate after-tax income for the group of families in the highest income quintile would be higher under the flat tax (a net tax cut). However, compared to the proposal without exemptions, the Armey-style proposal would cause a smaller reduction in aggregate after-tax income (between 1.0 percent and 2.2 percent of current-law after-tax income) for the group of families in the first through fourth income quintiles. The percentage increase in after-tax income for the group of families in the highest income quintile, 1.6 percent, would also be smaller than the increase shown in Table 1. These changes amount to aggregate increases in Federal taxes ranging from 8.9 percent to 12.2 percent for the group of families in the first through fourth income quintiles (compared to 15.5 percent and 134.1 percent, respectively, under the proposal without exemptions), and a 5.6 percent reduction in taxes (compared to 18.6 percent in Table 1) for the group of families in the highest income quintile.[9]

Table 3 compares the progressivity of the current Federal tax system together with the revenue-neutral, stylized flat tax described above. The last two columns in the table show taxes as a percentage of pre-tax income (effective tax rates) for groups of taxpayers. The current tax system is progressive with respect to income by quintile -- that is, effective tax rates rise with each income quintile -- and the flat tax is progressive through the fourth income quintile, although the effective tax rate falls slightly from the fourth income quintile to the highest. The flat tax proposal, however, ceases to be progressive for the group of families with the very highest incomes. The effective tax rates for the groups of families in the top ten percent, five percent, and one percent of the income distribution fall to 20.2 percent, 18.8 percent, and 16.4 percent, compared with a rate of 21.7 percent for families in the fourth income quintile. Under current law, effective tax rates continue to rise for the families with the very highest incomes.[10] This decrease in tax burden on higher-income families under the flat tax occurs because income from new saving and investment (which is not taxed under a consumption tax) is concentrated among families at the top of the income distribution.

While Treasury has not completed a study of the distributional effect of the Nunn-Domenici consumption tax, their proposal was designed to achieve progressivity through graduated rates under the individual consumed income tax. A top statutory individual tax

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[8]Except for the inclusion of standard deductions and personal exemptions and the disallowance of certain deductions for taxes paid by businesses, the distributional estimates shown in the Table 2 are based on the same assumptions as those in Table 1.

[9]These results are illustrated in Chart 2.

[10]These results are illustrated in Chart 3.

Table 3
Replace Current Individual and Corporate Income Taxes with a 22.9% (Modified) Flat Rate Tax (1)

(1996 Income Levels)

Family Economic Income Quintile (2)	Federal Taxes Under Current Law (3) ($B)	Federal Taxes with 22.9% Flat Rate Tax (4) ($B)	Change in Federal Taxes ($B)	Taxes as a Percent of Pre-Tax Income Under: Current Law (%)	Taxes as a Percent of Pre-Tax Income Under: with 22.9% Flat Rate Tax (%)
Lowest (7)	14.2	15.9	1.7	7.6	8.6
Second	61.2	66.4	5.2	12.4	13.5
Third	146.5	158.7	12.2	17.3	18.8
Fourth	271.8	296.0	24.2	19.9	21.7
Highest	779.5	736.2	-43.3	22.4	21.2
Total (7)	1275.1	1275.1	0.0	20.1	20.1
Top 10%	565.3	498.3	-67.0	22.9	20.2
Top 5%	415.3	335.6	-79.7	23.2	18.8
Top 1%	221.9	148.3	-73.7	24.5	16.4

Department of the Treasury
Office of Tax Analysis

June 5, 1995

(1) This table distributes the estimated change in Federal taxes due to a (modified) flat rate tax with a revenue-neutral rate of 22.9 percent (approximately) which replaces the current individual and corporate income taxes.

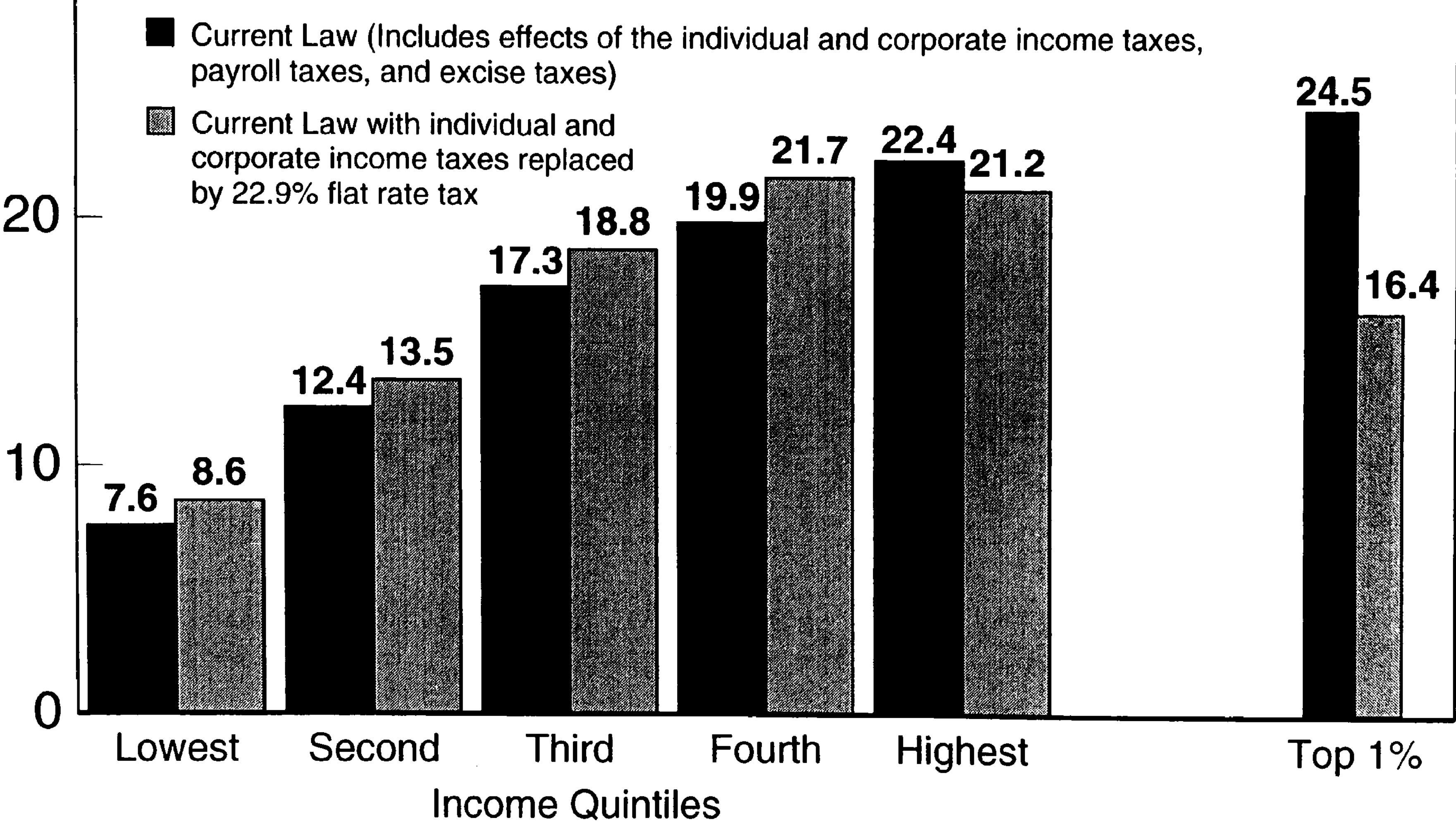
(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments, such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family, rather than on a tax return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) The taxes included are individual and corporate income, payroll (Social Security and unemployment), and excises. Estate and gift taxes and customs duties are excluded. The individual income tax is assumed to be borne by payors, the corporate income tax by capital income generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals by the purchaser, and excises on purchases by business in proportion to total consumption expenditures. Taxes due to provisions that expire prior to the end of the Budget period (i.e., before 2000) are excluded.

(4) The change in Federal taxes is estimated at 1996 income levels but assuming fully phased in law and static behavior. The incidence assumptions for the repealed income taxes is the same as for the current law taxes (see footnote 3). The flat tax on wages (plus pension benefits received) is assumed to be borne by wages plus pension benefits received in excess of the standard deduction. The flat tax on employer-provided fringe benefits (except pension contributions) and payroll taxes is assumed to be borne by employees in proportion to benefits or taxes. The flat tax on business cash flow is assumed to be borne by capital income generally.
The standard deduction (in 1995$) is $24,700 (joint) or $12,350 (single) plus $5,000 for each dependent. Non-pension fringe benefits of government and nonprofit employees are included in wages.
The proposal would disallow a deduction for employer-provided fringe benefits (except pension contributions) making these benefits (primarily employer-provided health insurance) subject to the 22.9 percent flat tax. The employer portion of payroll taxes would likewise be nondeductible.

(5) Families with negative incomes are included in the total line but not shown separately.

Chart 3: Distributional Effect of Federal Tax System Under Current Law and With Income Taxes Replaced by a 22.9% (Modified) Flat Rate ConsumptionTax



Source: Department of the Treasury

rate of 40 percent, together with the loss of a deduction for labor costs under the 11 percent business tax, means that consumed labor income in excess of $24,000 (for joint filers) would be taxed at an effective rate of 46.6 percent under the Nunn-Domenici proposal. With the family living allowance and personal and dependent exemptions, a family of four would pay income tax at an effective rate of 46.6 percent on consumed labor income in excess of $41,600.

As an alternative to a complete replacement of the income tax system, a VAT or BTT could be imposed at a moderate rate to replace a portion of the revenue from the income tax. A variant of this approach, taken by Representative Gibbons, would impose a VAT to replace most of the revenue from income and payroll taxes, but would retain an income tax for high-income individuals to ensure that they continue to pay an equitable share of taxes. Refundable credits or other mechanisms could be used to offset the effects of the consumption tax on low-income families.

While consumption taxes can be made less regressive, there is a clear and important tradeoff between progressivity and simplicity. The forms of tax that are the simplest and probably the least costly to administer and with which to comply (the RST and VAT) cannot be made progressive without retaining some income-based taxes on high-income families and credits for low-income families. The forms that are collected solely from individuals are more easily made progressive, but would be at least as complex -- and probably *more* complex -- than our current tax system. Consumption taxes collected from individuals -- such as the individual portion of the Nunn-Domenici USA Tax -- would impose numerous reporting requirements on taxpayers and would introduce complicated tax calculations in ways that would be new to taxpayers, tax preparers, and the IRS. I will describe some of these complexities in more detail later in my testimony when I evaluate the effects of tax reform on simplicity.

Transition from the existing income tax to a new consumption tax raises an additional series of issues regarding equity, compliance, economic efficiency, and the impact on wages, prices, interest rates, and the values of assets. These important issues are also discussed below.

Economic effects of replacing the income tax with a consumption tax[11]

Saving and investment[12]

The main reason to consider replacing the income tax with a consumption tax is that this change could encourage domestic saving and capital formation and promote economic growth. A consumption tax would not tax the return to new saving and investment. The income tax does tax this return, and thereby discourages saving and investment to some degree. The key issue is whether substituting a consumption tax for an income tax will raise saving enough to overcome its other problems.

1. National saving. The low rate of U.S. saving is a serious concern. The national saving rate in the United States has declined in the 1980s compared to the previous three decades (Table 4). Although private saving decreased during this period, it remained positive. Public saving, however, has been consistently negative as a result of Federal budget deficits.

Table 4. Components of Net U.S. National Savings as a Percentage of GDP: 1950-1994

Year	Net Personal Saving	Net Business Saving	Total Net Private Saving	Public Saving	Total Net National Saving
Average 1950-59	4.7	2.9	7.6	-0.1	7.5
Average 1960-69	4.7	3.6	8.2	-0.1	8.1
Average 1970-79	5.5	2.6	8.1	-1.0	7.2
Average 1980-89	4.5	1.5	6.0	-2.4	3.6
Average 1990-94	3.4	1.8	5.1	-3.1	2.1

Source: Department of Commerce, Bureau of Economic Analysis

[11]This section analyzes the long-run economic effects of switching to a consumption tax system. The short-run effects could be quite different from the long-run effects, but analysis of short-run effects is beyond the scope of this testimony.

[12]Discussion of the points made in this section of the testimony appears in Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 44-52; U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, Congressional Budget Office, 1992, pp. 51-5; and Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving*, U.S. Government Printing Office, 1995, pp. 63-72.

The reasons for the decline in private saving rates in the United States are unclear. It could be due to demographic factors that may reverse as the baby boom generation enters later middle age and saves for retirement. It may also be attributable to an increase in the availability of insurance and Social Security benefits, which reduce the necessity for private saving.[13] The decline in saving does not appear to have been caused by changes in tax policy. Marginal tax rates were lowered substantially during the 1980s and new saving incentives were introduced, but the rate of saving still fell.

According to a recent report by the Organization for Economic Cooperation and Development, the saving rates of our major trading partners also have declined since the 1960s.[14] All of these countries except Japan, however, rely more heavily on consumption taxes for revenues than does the United States, both as a percentage of gross domestic product (GDP) and as a share of total tax revenues (Tables 5 and 6). While Japan depends the least on consumption taxes for revenues, it also had the highest saving rate during the 1980s (Table 7) and the highest rate of growth in real per capita GDP (Table 8).

The most direct way to increase national saving is to reduce the Federal budget deficit. The Federal government may also be able to affect private saving through changes in tax policy. However, if tax policy changes also increase the Federal budget deficit, there may be no net increase in national saving.

[13]For a more detailed discussion, see Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving*, U.S. Government Printing Office, 1991, p 72.

[14]Organization for Economic Cooperation and Development, *Taxation and Household Saving*, 1994, pp. 17-24.

Table 5. Tax Revenues by Type of Tax as a Percentage of GDP for Selected Countries: 1992[1]

	Total	Income & Profits	Social Security	Property	Goods & Services	Other[2]
Canada	36.5	16.4	6.0	4.0	9.5	0.5
France	43.6	7.6	19.5	2.2	11.7	2.7
Germany	39.6	12.7	15.2	1.1	10.6	0.0
Italy	42.4	16.6	13.3	1.0	11.4	0.1
Japan	29.4	12.5	9.7	3.1	4.1	0.1
United Kingdom	35.2	12.7	6.3	2.8	12.1	1.3
United States	29.4	12.2	8.8	3.3	5.0	-

Source: Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries, 1965-1993, 1994.

[1] Includes taxes at all levels of government.
[2] Includes certain payroll taxes that are not earmarked for social security, taxes imposed on other bases not otherwise identified or identifiable and fines and penalties.

Table 6. Tax Revenues by Type of Tax as a Percentage of Total Taxation for Selected Countries: 1992[1]

	Income & Profits	Social Security	Property	Goods & Services	Other[2]
Canada	45.0	16.5	11.1	26.1	1.4
France	17.3	44.6	5.0	26.8	6.3
Germany	32.0	38.4	2.7	26.9	-
Italy	39.1	31.3	2.4	26.9	0.3
Japan	42.4	32.8	10.5	14.0	0.3
United Kingdom	36.1	17.8	7.9	34.4	3.7
United States	41.5	29.9	11.4	17.1	-

Source: Organization for Economic Cooperation and Development, Revenue Statistics of OECD Member Countries, 1965-1993, 1994.

[1] Includes taxes at all levels of government.
[2] Includes certain payroll taxes that are not earmarked for social security, taxes imposed on other bases not otherwise identified or identifiable and fines and penalties.

Table 7. Average Net National Saving Rates for Selected Countries

Country	1980's	1990	1991	1992
Canada	8.4	5.0	2.5	1.5
France	7.9	8.6	7.6	6.5
Germany	9.8	12.5	10.4	9.8
Italy	9.8	7.8	6.8	5.2
Japan	18.2	19.8	20.0	18.2
United Kingdom	4.8	3.6	2.4	2.0
United States	4.5	3.1	2.8	1.9

Source: OECD, National Accounts 1980-1992, 1994.

Note: Data are based on the OECD System of National Accounts (SNA) methodology which differs slightly from the U.S. National Income Accounts System.

Table 8. Average Annual Growth Rates of Real Per Capita GDP for Selected Countries: 1980-1992 (percent)

Country	1980 to 1990	1990 to 1992
Canada	1.9	-1.9
France	1.8	0.4
Germany	2.0	2.0
Italy	2.0	0.9
Japan	3.5	2.4
United Kingdom	2.5	-1.8
United States	1.8	-0.1

Source: Organization for Economic Cooperation and Development

2. Tax policy and private saving. Two effects from substituting a consumption tax for the income tax could boost total private saving. Economic theory suggests that if the after-tax rate of return on savings goes up, individuals would increase saving to consume more in the future since the "price" of future consumption in terms of foregone current consumption is lower. However, most empirical studies find that the effect of increasing the

rate of return on the level of saving would be quite small.[15] In addition, some people are "savers," while others consume essentially all their income. Shifting the overall burden of taxes from saver to consumer households can increase aggregate private saving, but it would also result in an increased concentration of private wealth.

While a pure consumption tax would encourage private saving more than a pure income tax, the effect on saving of substituting a consumption tax for our existing income tax is less clear. Our current income tax includes powerful incentives for employees to receive part of their compensation in the form of retirement savings plan contributions, and for employers to provide such plans for all their employees -- including low-income employees who would not be likely to respond to direct tax incentives. The incentive to establish retirement plans would be much weaker under a consumption tax.

An alternative way to use tax policy to increase private saving is to broaden saving incentives within the framework of the existing income tax. Provisions that directly encourage people to deposit some of their earnings in tax-favored accounts, such as IRAs and 401(k) plans, could be more cost-effective ways of increasing saving without replacing the entire tax system. Toward that end, the Administration's budget has proposed an expansion in the eligibility rules for contributing to IRAs.

3. Saving and investment. Advocates of replacing the income tax with a consumption tax often discuss effects on saving and investment as if they are interchangeable. But saving and investment can diverge significantly because of the increased amount of international capital flows in today's global economy. More specifically, the relative effects on saving and investment would depend in part on the extent to which the consumption tax revenues were used to reduce corporate or individual income tax rates. Eliminating the corporate tax would increase domestic investment more than private saving, while eliminating the individual tax would increase private saving more than domestic investment.[16]

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[15]See Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving*, U.S. Government Printing Office, 1995, p. 46. For additional discussion of this point, see Organization for Economic Cooperation and Development, *Taxation and Household Saving*, 1994. In *Descriptions and Analysis of Proposals to Replace the Federal Income Tax* (U.S. Government Printing Office, 1995, p. 69), the staff of the Joint Committee on Taxation states that the results of studies of the empirical response of saving to changes in the after-tax rate-of-return are inconclusive.

[16]Under U.S. tax rules, corporate income tax is imposed on the return to equity-financed capital used in the United States regardless of who owns it, whereas the individual income tax is imposed on the return to capital owned by U.S. residents regardless of where it is used. (U.S. corporations are taxed on their worldwide income, but receive a tax credit for foreign income taxes paid. The residual U.S. tax rate on active foreign-source income of U.S. corporations, after accounting for foreign taxes, is generally quite low.) Eliminating the corporate tax would be expected to increase domestic investment more than saving, because it would reduce the cost of capital to both U.S. corporations and foreign corporations investing in the United States by much more than it would increase the after-tax return to U.S. savers. In contrast, eliminating the individual income tax would be expected to increase saving more than domestic investment because it would increase the after-tax return to U.S. personal saving invested both in the United States and abroad, but, with internationally-linked

4. Interest rates. It is not clear how a switch to a consumption tax would affect U.S. interest rates in the long run.[17] The net demand by U.S. investors for interest-bearing assets would be expected to increase, pushing bond prices up and yields down. This would occur because the consumption tax would remove interest flows from tax calculations. Also, under a consumption tax, domestic borrowers would not be willing to pay as high a rate of interest because interest would no longer be deductible, and U.S. lenders would be willing to accept a lower rate of interest because interest income would no longer be taxed. But in today's world economy, the U.S. interest rate is closely linked to rates in other advanced countries. With foreign interest rates unchanged and debt capital flowing freely across international borders, any reduction in U.S. interest rates would be dampened significantly. The likely result is that U.S. interest rates would fall somewhat, but by much less than the initial tax benefit to savers. After-tax yields to U.S. savers and after-tax interest costs to U.S. borrowers would increase.

Prices and wages

A frequent concern is that the introduction of certain types of consumption taxes, particularly RSTs and VATs, would lead to a higher price level because such taxes are generally added to the price of the product.

It is likely that such a one-time increase in the prices of consumption goods could occur. In addition, the indexing provisions of social welfare benefits and some labor contracts could lead to continuing inflationary pressures in later periods as a delayed effect of the initial price level change. The extent of this one-time increase and any further increases in the price level depend on the actions of the Federal Reserve. Such price increases can only occur if the Federal Reserve provides accommodative monetary policy.[18,19]

If the introduction of a consumption tax does lead to an increase in the overall price level, wage-earners will suffer a proportionate reduction in their purchasing power. If the price level does not rise, however, after-tax payments to factors of production such as wages would have to be reduced. In either case, the net after-tax returns to labor are likely to be reduced under a consumption tax because of the need to obtain revenues to offset the reduction in taxes on capital income.

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capital markets, would not provide a relative advantage to capital invested in the United States.

[17]The short-run effects on interest rates would depend on actions taken by the Federal Reserve during the period of transition to a new tax system.

[18]For additional discussion of the effects on prices of adopting a VAT, see U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, Congressional Budget Office, 1992, pp. 64-65.

[19]If the consumption tax is a replacement for part of the income tax, however, there may be decreases in the prices of investment goods that would produce an offsetting effect and further reduce the likelihood of price increases.

Asset values

Changing from income taxation to consumption taxation is likely to have material effects on the values of different kinds of assets. It is clear that there will be major winners and losers. But it is difficult to identify all effects on assets because such effects depend in complex ways on the details of specific proposals and on the economic responses to some of the changes. We can only comment generally on what some of the effects might be.

Several economists have argued that expensing of new investments under a consumption tax will adversely affect stock prices to the extent that those prices reflect the value of existing capital.[20] Expensing of new investment lowers the rental price of capital that is required to make new investment profitable. These lower rents, in turn, depress the value of claims to existing assets. But the actual effect on the overall level of stock prices is likely to be less than predicted by these studies. These studies are based on changing from pure income to pure consumption taxes, but the current income tax system already incorporates some features of a consumption tax such as accelerated depreciation and savings preferences. The short-run adverse effects on overall levels of stock prices are likely to be further cushioned because the adjustment costs associated with incorporating new investment will reduce the rate at which the capital stock increases. This will keep rental returns of capital from falling by maintaining the value of scarce capital.[21]

The exemption under a consumption tax for interest income and the elimination of interest deductions would tend to reduce interest rates, pushing up the price of existing taxable bonds. But in today's international capital markets, high-grade bonds of different countries are close substitutes. Consequently, a change in the tax treatment of debt in the United States is not likely to affect world interest rates. On net, interest rates in the United States would probably fall only slightly in response to the imposition of a consumption tax, pushing bond values up only slightly.

If the consumption tax is collected from businesses, and the Federal Reserve accommodates the tax by expanding the money supply, the price level will rise. Increased prices will effectively transfer real wealth from lenders (current holders of long-term bonds) to borrowers (current issuers of long-term bonds). New borrowers and lenders would be unaffected by this wealth transfer.

Tax-exempt interest rates would be expected to rise in response to a switch to a consumption tax because, under most consumption tax proposals, tax-exempt bonds would no

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[20]See, for example, Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987, and David Bradford "Consumption Tax Alternatives: Implementation and Transition Issues," paper at Hoover Institution Conference, May 11, 1995.

[21]See Andrew Lyon, "The Effect of the Investment Tax Credit on the Value of the Firm," *Journal of Public Economics*, 38 (1988), pp.227-247.

longer be favored relative to taxable bonds. Consequently, existing holders of long-term municipal bonds would suffer a capital loss.

Under the current income tax, investment in owner occupied housing is substantially tax favored compared to other forms of investment. These advantages include allowing deductions for certain homeownership costs, such as mortgage interest and property taxes, even though housing produces no taxable income. Under most consumption tax proposals, housing would lose its relative advantage over other forms of investment. The switch to a consumption tax would affect housing most directly through the repeal of the mortgage interest deduction and corresponding elimination of the tax on interest income. Consequently, the cost of both debt and equity capital invested in housing would increase.[22] The loss of preferential treatment means that the consumption benefits from housing would rise relative to the returns from other investment. This would lower the price of existing housing and substantially reduce the number of new homes that are built.[23] In the absence of special transition rules or a continuation of tax preferences, housing values could fall considerably in the short run. Over time, the housing stock would be expected to decline, and the resulting scarcity of homes would push the prices of existing houses back towards their initial level.

Economic efficiency

1. Allocation of capital.

Because a consumption tax does not tax the return to new investment and treats all businesses uniformly, it would not favor some assets or industries over others. Unlike the current U.S. income tax, it would not favor non-corporate over corporate investment or investments in capital owned by State and local governments, owner-occupied housing, consumer durables, and other personal assets over business investments. As a consequence, investors would be encouraged to hold assets that were expected to produce the highest economic returns. Investment would be expected to shift out of the sectors that enjoy favor under the income tax -- owner-occupied housing, other personal assets, and noncorporate and State and local capital -- and into corporate capital. In addition, a consumption tax, unlike the current income tax, would not favor corporate debt over equity financing, reducing tax considerations from business financial decisions.

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[22]A similar conclusion is drawn in Joint Committee on Taxation, *Descriptions and Analysis of Proposals to Replace the Income Tax*, 1995, U.S. Government Printing Office, p. 86.

[23]The decline in housing prices would be proportionately greater for high-priced homes than for low-priced homes. The owners of high-priced homes are typically in high tax brackets, making the mortgage interest deduction relatively more valuable to them, while the owners of low-priced homes may be in low brackets or may be non-itemizers.

The resulting gains in economic efficiency are substantially reduced if the replacement consumption tax departs from a very broad base. However, such departures may be desired for a number of reasons. For example, most countries attempt to reduce the number of taxpayers in the system by exempting small businesses from the VAT. Some industries, such as banking and insurance, are typically excluded from the VAT because their tax bases are difficult to define. Some forms of capital, such as owner-occupied housing, might be given a preference to support social and economic goals. Each such exemption reduces the efficiency and simplification benefits attributable to the uniform treatment of capital.

2. Taxation of existing wealth.

Economic analyses show that much of the gain in economic efficiency predicted to result from a switch to a consumption tax arises from the taxation of wealth in place at the time of transition to the new tax. Saving and investment that take place after the imposition of a consumption tax will be exempt from tax, but consumption out of existing wealth will be taxed, unless provisions are made to relieve this burden explicitly. Economists believe that a tax on existing wealth will not distort taxpayer behavior. Therefore, collecting revenue through this non-distorting tax will allow lower tax rates on the remainder of the consumption tax base, significantly increasing economic efficiency. Nevertheless, a full or partial exemption for existing wealth might be desired to prevent savings that had been taxed under the income tax from being taxed a second time under the consumption tax. An exemption for all existing wealth would effectively convert the consumption tax to a tax on wage income alone, however, requiring higher tax rates on wages to compensate for the lost revenue.[24] Consequently, allowing a full exemption for existing wealth under a new consumption tax will substantially reduce, and could entirely eliminate, the gains in economic efficiency that many economists expect from the switch.[25]

3. Labor supply.

Both an income tax and a consumption tax affect the choice between work and leisure by reducing the relative purchasing power of wages. An income tax reduces the relative value of wages by taxing them directly. A consumption tax that is collected from businesses reduces the value of wages to the extent that the business tax is passed forward to consumers in the form of higher prices or back to workers in the form of lower wages.[26]

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[24]A consumption tax with an exemption for existing wealth would be levied not only on wages, but would also collect revenue on profits that reflect "economic rents," for example, profits resulting from the ownership of a monopoly.

[25]For a discussion of the relative economic benefits of a consumption tax, wage tax, and income tax, see Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987.

[26]See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, p. 57.

The effect on labor supply of switching to a consumption tax depends on changes in effective tax rates. Effective tax rates reflect the combined effects of the statutory rate structure and other tax proposal provisions, such as denying deductions for wages and employee fringe benefits at the business level and retaining payroll taxes. Examining the proposed statutory rate structure alone would overstate the possible decline in tax rates and the increase in work incentives.

4. Consumption-saving choice.

One source of economic inefficiency under an income tax is the distortion the tax imposes on a consumer's choice of how much to save. Because an income tax is imposed on the return to savings, it effectively increases the "price" of consumption in the future in terms of consumption foregone today. That is, under an income tax, a consumer must deposit more money in the bank today to finance a given amount of spending in the future than would be required in the absence of the income tax. Economic theory suggests that this increase in the price of future consumption reduces consumers' incentive to save. A consumption tax, which does not tax the return to savings, does not increase the price of future consumption relative to current consumption. A consumption tax is, therefore, neutral with respect to the consumer's choice of how much to save. As I stated earlier in my testimony, however, while economic theory suggests that individuals might increase saving in response to the higher return to saving resulting from the switch to a consumption tax, most empirical studies find that the effect of increasing the rate of return on the level of saving would be quite small.

International trade

It is sometimes argued that, because indirect taxes can be imposed on imports and refunded on exports, the adoption of a VAT or other indirect consumption tax to replace part or all of our current income taxes would encourage U.S. exports. However, trade economists generally agree that such a tax change would not permanently improve either U.S. exports or the U.S. trade balance.[27]

To see how a refund or exemption for exports under a consumption tax and the imposition of the tax on imports (called border tax adjustments), in fact, amount to neither a subsidy for domestic exports nor a penalty on imported goods, consider a very simple example. Imagine that both New York and New Jersey produce apples for consumption within the state and for "export" to neighboring states. Assume a competitive market for apples sets the price per bushel at $5.00. Now imagine that New York adopts a broad-based, 10 percent VAT that exempts exports and is imposed on imports. The price of apples produced and bought in New York would be expected to rise to $5.50. Since the New

[27]See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, p. 63. A similar conclusion is drawn in Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*, U.S. Government Printing Office, 1995, pp. 69-70.

Jersey apples that are trucked into New York are subject to the 10 percent VAT, they would also sell for $5.50 per bushel. Imports into New York would, therefore, not be penalized relative to domestic produce. Over the border, New Jersey apples would still sell for $5.00 per bushel, as would imported New York apples that are exempt from New York's VAT. The exemption for exports, therefore, results in no subsidy for New York's exports.[28]

While adopting a consumption tax with border tax adjustments is generally considered to have no long-run effect on the balance of trade, eliminating or substantially reducing income taxes could affect the trade balance, because income taxes may discourage both saving by U.S. residents and investment in the United States, and lowering U.S. income taxes could affect private saving and investment by differing and uncertain amounts. If private saving increased more than investment, the United States would import less capital and net exports would increase; if investment increased more than private saving, net exports would decline. Which effect would dominate depends on the specific form of the income tax cut and on the relative responsiveness of saving and investment.

Eliminating or reducing U.S. income taxes could also affect the relative competitiveness of different industries, because the income tax imposes different effective tax rates on production in different economic sectors. For example, reducing the cost of capital in the United States would generally favor the production of capital-intensive goods over labor-intensive goods. This differential benefit would affect the composition of trade, because goods that became relatively more expensive to produce in the United States would be increasingly imported, and goods that became relatively inexpensive to produce at home would be increasingly exported. However, there is little reason to believe that the net trade balance would be much affected by this change in relative trade positions.[29]

Although border tax adjustments under a consumption tax are generally considered to have no long-run affect on the balance of trade, it should be noted that some types of consumption taxes are accepted as border-adjustable under the General Agreement on Tariffs and Trade (GATT), and others are not. Indirect taxes, such as credit-invoice VATs used in most other countries, are border-adjustable under the GATT. Consumption taxes collected wholly or in part from individuals, such as a consumed income tax and a flat-rate tax of the type proposed by Representative Armey and Senator Specter, are unlikely to be refundable under the GATT. Although a broad-based, single-rate subtraction method VAT is

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[28]It is not necessary to have border tax adjustments to obtain this result. If the market price for apples is $5.00, it will not be possible for producers to increase the price charged or lower the price and remain in business. Labor will bear the burden of the tax through a fall in wages and there will be no effect on trade between New York and New Jersey. In the international context, it is also possible for the currency of the country that imposed the tax to depreciate, offsetting the effect of the tax on the exported good.

[29]The Joint Committee on Taxation finds that replacing part or all of the corporate income tax with a VAT does not directly affect the U.S. trade balance. See Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 303-4.

economically equivalent to a similarly broad-based credit-invoice VAT, a GATT ruling would consider other factors. Whether a subtraction method VAT would survive a GATT challenge is an untested issue.[30,31]

Sector-specific issues of adopting a consumption tax[32]

Special treatment may be appropriate for specific business sectors under those forms of tax that are collected at least in part from businesses. High administrative and compliance costs relative to revenue collected may justify special treatment for certain sectors and for small businesses. Special rules are required for taxing goods and services with hard-to-measure tax bases, such as financial services.[33] The tax base for these services is not explicitly separated from other charges, and it is difficult to apportion the benefit from financial services to those who receive them. For example, the charge for intermediation services provided by banks is included in the difference between the interest rates charged to borrowers and paid on deposits. That difference also includes the return to equity-holders. Moreover, it is difficult to allocate the intermediation charge to a specific savings account or loan.

While the current version of the Armey and Specter proposals contain no special rules for the treatment of financial institutions, the Nunn-Domenici plan would tax banks and insurance companies under a separate set of rules from those applied to non-financial businesses.[34]

[30]These points are discussed in more detail in Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 302-4, and U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 63-4.

[31]The Treasury Department responded on February 3, 1995, to a query by Senators Nunn and Domenici on this issue.

[32]These issues are discussed in detail in Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Congressional Budget Office, 1991, pp. 314-20, and U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 26-30.

[33]For a discussion of the difficulties related to taxing insurance and other financial services under a VAT, see Joint Committee on Taxation, *Factors Affecting the Competitiveness of the United States*, U.S. Government Printing Office, 1991, pp. 315-18.

[34]This is less of a problem under two-part consumption taxes like the Armey and Specter proposals than under other forms of consumption taxes, because the portion of value-added generated within the financial services sector by labor would be captured under the wage tax. Only the portion of value-added generated by capital would be lost.

Taxing governments and non-profit organizations is difficult because there often is no market price for their production and many are currently not subject to tax. Most countries with VATs attempt to tax the commercial operations of this sector, but this approach requires differentiating between taxable and non-taxable activities which can be administratively complex. While special treatment for specific sectors might ease administration of a consumption tax, exclusions from the tax base would increase economic distortions relative to a very broad-based consumption tax. The business tax portions of the Nunn-Domenici proposal would generally include the commercial activities of governments and many currently non-taxable non-profit organizations in the tax system.

Taxation of housing and consumer durables also raises important issues. To minimize economic distortions, rental housing, owner-occupied housing, and other durable goods should be treated similarly. When businesses are allowed to expense capital purchases, purchases of buildings or durables for use as rentals would be deductible, and rental receipts would be taxed. However, the same theoretical treatment of owner-occupied housing and durable goods would require taxing the total purchase price, which reflects the current value of the services the home or durable good provides over its useful life.[35] This approach can lead to significant tax bills for buyers and windfall gains for current owners, who would not owe tax on the consumption of their existing housing or durable good.

Many consumption tax proposals assume that exports will be relieved of the tax and imports will be taxed. Making the appropriate adjustments can be difficult if the tax base is not broad or if tax rates vary. Border adjustments for certain services also create complexity, because it is generally more difficult to determine the location of supply or purchase in the case of non-tangible services than for goods.

Simplicity

Simplification of the tax system is a primary goal of many tax reform proposals, and one which we support. A simpler tax system would have lower compliance costs for individuals and businesses, such as the costs related to learning the tax rules, recordkeeping, and preparing tax returns, and lower administrative costs for the government, such as the costs of processing tax returns and conducting audits.

To evaluate reform proposals on the basis of simplification, however, it is useful to examine the sources of the complexity that plagues our current system. One source of complexity, the measurement of capital income, would be reduced under some forms of consumption tax. Three other sources of complexity, the desire to distribute the tax burden equitably, the necessity to measure the consumption component of business income properly, and the use of the tax system to advance certain non-tax social and economic policies, would

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[35]See U.S. Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, U.S. Congressional Budget Office, 1992, pp. 28-9.

likely persist under any consumption tax. If a consumption tax were implemented in the United States, the final form of the tax would likely differ from the ideal for these same reasons. Divergence from the simple, broad-based, flat-rate, consumption tax model -- for whatever reason -- will tend to lead to complexity, with higher administrative and compliance costs, higher tax rates overall, and reduced efficiency gains.

Correctly measuring capital income is difficult, and approximations designed to reduce that complexity can invite tax avoidance and an inefficient use of economic resources. Therefore, one of the attractions of a consumption tax is that many of the onerous calculations related to capital income would be eliminated, and no tax would be owed on interest, dividends, and capital gains. Under a RST, capital purchases by businesses and capital income are excluded. Under a consumption tax levied at the business level, such as Representative Gibbon's VAT or the business tax portions of the Armey and Nunn-Domenici proposals, depreciation and other cost-recovery provisions would be replaced with expensing. Administrative and compliance costs would be reduced, since it would not be necessary to maintain records on asset costs in order to compute cost-recovery allowances and gains on the sale of assets.

Unlike the existing income tax, however, a consumed income tax collected from individuals would require the measurement of annual changes in wealth. As suggested earlier in this testimony, a consumed income tax system like the Nunn-Domenici individual level tax could, therefore, be at least as complex as the current system, posing numerous new taxpayer reporting requirements and introducing new tax concepts and calculations. Compliance costs are likely to be significant for individuals who must report their net savings, particularly for taxpayers that both borrow and save and roll over prior savings into new accounts, and for the banks, mutual funds and other businesses that would be required to provide reports on investment and borrowing activities of individuals. Under one approach to a consumed income tax, proceeds from all forms of borrowing -- whether through a loan or a balance carried over to the next year on a credit card -- would be added to a family's tax base. The net contribution to all forms of savings would be deducted from the tax base and withdrawals from savings would be taxed. It might not be complicated to calculate tax liability under this approach for a family that borrowed no money during the year, had no end-of-the-year credit card balance, and only made contributions to a passbook savings account. But in the modern U.S. economy, even a moderate-income family might in a typical year purchase deductible mutual fund shares through a dividend reinvestment plan, sell a taxable bond, and carry taxable balances on several credit cards. Some proposals might not require families to pay tax on some minimum amount of borrowing, such as under the Nunn-Domenici proposal, or might allow tax-free withdrawals from savings in cases of hardship, but these modifications would require complex rules to determine eligibility for exemptions and to prevent tax avoidance.

Distribution of the tax burden

Most of the mechanisms available under a consumption tax for minimizing the regressivity of the tax introduce complexities and their resultant costs. Exempting certain goods and services from a national RST or VAT and taxing others at alternate rates increases the compliance burden on businesses that would have to determine which rates to charge for their products and, in some cases, would be required to apportion their deductible costs among taxable and non-taxable sales. To make up the revenue loss from reducing tax on some goods and services, tax rates on the remaining goods and services would have to be raised. None of the proposals discussed in this testimony exempt specific goods and services, though State retail sales taxes in the United States and VATs in most OECD countries do use this approach.

A tax that is collected wholly or in part from individuals can be applied at graduated tax rates, which would complicate the tax slightly: it is not much more difficult for taxpayers to look up their tax liability on a table -- as they do now -- than it would be for them to apply a single rate to all taxable income. In the case of a two-part consumption tax, like the Armey proposal, ensuring that the same top statutory rate applies to both individuals and businesses would lower administration and compliance costs by enabling taxes on some forms of income to be collected wholly from businesses.

Many consumption tax proposals, such as those of Gibbons, Armey, and Nunn and Domenici, offer large standard deductions and exemptions for dependents in order to relieve some income from tax and to remove large numbers of people from the tax system altogether. The latter benefit is reduced, however, if refundable tax credits -- like the EITC -- are used to minimize the burden of the tax, as is done in some proposals. Low-income families that otherwise might not be required to file a tax return would have to fill out a return in order to receive the credit. So that credits can be targeted to needy households, a family might be required to calculate income, which it otherwise would not have to report under some forms of a consumption tax. The relative increase in administrative and compliance burdens of offering refundable credits might be small in the case of a consumed income tax, under which much of the income tax structure would be retained. The relative burden would be more significant, however, if the income tax had been completely replaced by a business-level consumption tax.

Measuring consumption

Like the existing income tax, a consumption tax that is collected from businesses, such as a VAT or two-part flat tax, would require rules for determining deductible business costs. Some business purchases have a consumption component that should be excluded from deductible business purchases. For example, a business' purchase of a company car that is also available for an employee's personal use has a consumption component, as do many business expenditures for travel and entertainment. The rules for determining allowable costs under a consumption tax would be similarly complex to the related rules

under the income tax. Moreover, the timing of deductions for capital purchases would make the problem more serious under a consumption tax. Under a consumption tax, business assets would be expensed, accelerating the benefit received by the taxpayer -- and tax revenue lost to the government-- from circumventing the rules.

Promoting social and economic goals

A U.S. consumption tax is likely to be used to advance certain widely-held social and economic goals. To the extent that these goals are promoted through the tax system, administrative and compliance costs are increased under a consumption tax as they are now under the current income tax system. Home-ownership is treated preferentially under the current income tax primarily by allowing families a deduction for interest they paid on their home mortgages. Allowing current law treatment of mortgage interest under a consumption tax would encourage homeowners to incur additional borrowing beyond their financing needs. Because mortgage loan proceeds under current law are not included in taxable income, while the amounts deposited in a savings account under a consumption tax would be deductible, mortgage loans used to transfer money to a savings account would reduce tax liability. In addition, allowing only some forms of loans to be exempt, such as under the Nunn-Domenici proposal, would introduce complexity and distortions relative to a system that treated all borrowing equally. As under the existing income tax, taxpayers would have an incentive to reclassify all forms of household debt as mortgage debt to maximize the benefit of the tax preference.

Deductions for charitable contributions and State and local taxes paid could be allowed for families under a consumed income tax and for wage-earners and businesses under a two-part consumption tax. A tax preference for employer purchases of health insurance and fringe benefits could be provided under a two-part consumption tax by allowing businesses to deduct these costs. Under an individual-level consumption tax, employer-provided health insurance and other fringe benefits could be taxed by imputing their value to the recipients and including the imputed value in taxable income; not imputing the value to recipients would treat these benefits preferentially relative to other forms of compensation. Each of these tax preferences, however, would require rules to determine which fringe benefits are included in or excluded from the tax base, and these rules would be equally complex as those under current law. Rules would also be required to determine which business expenses to include or exclude from the tax base. The Armey and Specter proposals would disallow deductions for state and local taxes, and the employer portion of the FICA tax. The Nunn-Domenici proposal also would disallow those deductions, but would permit a credit for the employer portion of the payroll tax.

The underground economy

The underground economy consists of illegal activities and those which are "informal," but not illegal. A suggested benefit of a consumption tax system is that it may promote greater compliance with the tax laws from those presently operating in the

underground economy. Some commentators have suggested that a consumption tax collected at the business level would enable tax to be imposed on income of the underground economy, particularly the informal sector, that is untaxed under the current individual income tax.

This benefit may easily be overstated. The reporting of income and sales from illegal activities, such as sales of illegal drugs, is unlikely to be affected by changes in the tax system. Incentives for not reporting income or sales from informal activities are likely to be similar under an individual income tax or a business-level consumption tax. For example, an electrician who does not pay income tax can charge a lower price, just as an electrician who does not collect a national RST or VAT for his services. Since income and sales from purchases of goods and services in the legal sector by the underground economy, such as the electrician's tools and supplies, are taxable now, it is unclear whether additional revenues would be obtained from this source by switching to a consumption tax.

Coordination with State and local sales taxes

An additional administrative consideration is the coordination of a Federal consumption tax with State and local government tax systems. Historically, States have depended heavily on retail sales taxes and excise taxes for revenues.[36] The adoption of a national sales tax or Federal VAT is likely to be seen as an infringement upon this important revenue source for State and local governments. In addition, a Federal VAT or national sales tax would create a new type of tax for businesses to administer. Some businesses would be responsible for either the VAT (or national RST) or a State sales tax, while others would be liable for both. The amount of State sales tax or VAT (or national RST) collected would depend on which tax was applied first and whether that tax was included in the tax base for the other one. Particular goods and services might be taxable under a VAT (or national RST) and exempted under the State sales tax, or vice versa, thereby creating additional administrative and compliance problems. Although sales taxes are generally under the purview of the States, the closeness of the tax bases would put the States under pressure to conform to Federal law.

Transition to a consumption tax and the tax on existing wealth

The most significant issue in converting from an income to a consumption tax system is deciding how to treat the return to wealth that was accumulated out of after-tax income under the income tax. The return to new saving and investment would be exempt under a consumption tax, but without an explicit exemption for old wealth, the return to and withdrawals from the stock of existing assets that are not reinvested will be taxed. For example, imposing a Federal VAT would automatically tax all withdrawals from existing savings that are used for consumption -- even if those savings were accumulated out of after-

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[36]See Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, Volume 2*, Washington, DC, 1994, Table 31, p.4.

tax income. A full or partial exemption for current wealth might be desired to relieve the tax burden on individuals with accumulated savings, many of whom are elderly. But such an exemption would reduce the taxes paid by the holders of wealth, making the tax less progressive. In addition, economists believe that a tax on existing wealth would not distort taxpayer behavior, and that this non-distorting wealth tax is the source of much of the gain in economic efficiency predicted to result from a switch to a consumption tax. Consequently, an exemption for all existing wealth would effectively convert the tax into a tax on wage income alone, requiring higher tax rates on wages. The effect would be to reduce significantly, and possibly completely eliminate, the gains in economic efficiency that some economists expect from a consumption tax.[37]

To illustrate the magnitude of this problem, consider the value of current household wealth. The total wealth of U.S. households is estimated at about $23 trillion.[38] Much of this wealth is in the form of assets, such as pensions and unrealized capital gains, which have not yet been taxed. Excluding housing, the basis of private assets in the United States could be as much as $10 trillion. Rules governing the treatment of consumption financed by existing wealth during the period of transition to the new tax will determine to what extent this significant amount of previously taxed savings is subject to the consumption tax. In this case, transition rules are not merely an inconsequential technical issue; how existing wealth is treated during the transition could have material economic effects.

Transition rules could be designed to relieve completely the tax burden on savers who have already paid income taxes on their savings and would otherwise be taxed again when those savings were spent under a consumed income tax. For example, without a transition rule for past savings, a retiree who accumulated $100,000 in a savings account out of after-tax income before the imposition of a consumption tax would be taxed on withdrawals from that account that are for consumption expenditures. A transition rule could allow savings that were accumulated under the income tax to be segregated from "new" savings and deducted from income. This rule would treat the $100,000 as tax-paid savings and would enable the retiree to make tax-free withdrawals from the savings account. It is difficult, however, to design rules that differentiate between individuals who reduce their accumulated savings in order to consume, and individuals who only rearrange assets among accounts. Allowing tax-free withdrawals from past savings, for example, would enable any individual with accumulated wealth to gain a tax deduction simply by transferring old assets into "new" savings accounts. Such a rule would enable a millionaire living off the interest on her accumulated assets, for example, to receive the equivalent of tax-free interest income -- a

[37]For a discussion of the relative economic benefits of a consumption tax, wage tax, and income tax, see Alan Auerbach and Laurence Kotlikoff, *Dynamic Fiscal Policy*, Cambridge University Press, 1987.

[38]Board of Governors of the Federal Reserve System, *Balance Sheets of U.S. Households*.

substantial benefit compared with current law.[39] The Nunn-Domenici plan includes detailed rules that would prevent the taxation of most previously-taxed savings while prohibiting taxpayers from generating savings deductions out of existing savings. While these rules would largely prevent the imposition of unfair burdens on elderly households, they would add to the complexity and costs of the tax system and would result in lower economic benefits than if the return to accumulated assets were subject to tax.

A similar problem exists for businesses that have purchased equipment prior to the tax change and have unused depreciation allowances. Denying depreciation deductions under the consumption tax would mean that businesses would not be able to recover fully the cost of those capital purchases, and that income from capital purchased before the effective date would be overtaxed. It would impose windfall losses on firms that invested prior to the effective date, placing them at a disadvantage relative to businesses that purchased equipment just after the effective date of the new consumption tax.

Transition rules could reduce windfall losses in this case, but they would likely sacrifice tax revenue and lead to greater complexity. For example, if the consumption tax is collected only at the business level, businesses could be allowed to deduct immediately the balance of their depreciation allowances, though little revenue would be collected from businesses during the early years of the tax under this scheme. Extending the depreciation deductions over a number of years, an approach taken by the Nunn-Domenici plan, would spread out the revenue loss, but it would require businesses to segregate old and new assets during the transition period and, therefore, would increase complexity.

Conclusion

A change as dramatic as replacing the income tax system with a consumption tax should only be attempted if the expected economic benefits of taxing consumption are reasonably certain to be larger than the total costs, burdens, and risks of moving to a completely new tax system. In making such a determination, it is misleading to compare a theoretically ideal consumption tax and the income tax system in place today. A realistic comparison would recognize that exclusions would likely be made under the replacement system -- either for administrative reasons or to support social and economic goals -- and that those exclusions would reduce the economic benefits of the change and increase complexity. A realistic comparison would also recognize that what we call an income tax in the United States is really a hybrid tax system. While it is based on income, it incorporates a number of consumption tax features that help promote saving. For example, contributions to

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[39]Under a transition rule that treats withdrawals from existing savings that are deposited into new savings accounts as new savings, an individual could draw down existing savings, deposit the amount in a new savings vehicle, and receive a tax deduction for the amount deposited. If the return to this "new" savings is used for consumption, the individual would pay tax on that return. But the original tax deduction would provide a benefit that would be equivalent to receiving the interest income tax-free. For an illustration of this result, see the example in the "Background" section of the testimony.

pensions, deductible IRAs, and other types of retirement savings are deducted from taxable income, and the earnings on these savings are not taxed until they are withdrawn. Most of the savings of middle-income Americans are in assets such as pensions and home equity that are already exempt from tax. Proposals for further reduction in taxes on income from savings of middle-income Americans, such as the proposal in the President's budget to expand the use of IRAs, should be carefully examined before we consider doing away with the income tax.

Based on all of the considerations described in my testimony today, we are not convinced that the case for completely replacing the income tax with a consumption tax is compelling. The most frequently cited economic benefit of such a change, an increase in private saving, is uncertain and could be small. The fairness of replacing the income tax with a consumption tax is also a concern. Moving to a flat-rate consumption tax would increase the tax burden on low-income families and lower the tax burden on high-income families. Efforts to improve the progressivity of consumption tax proposals result in complexity. In addition, the effect of switching to a consumption tax on wage and price levels, interest rates, and value of existing assets -- including homes -- is uncertain.

In general, divergence from the simple, broad-based, flat-rate, consumption tax model -- for administrative reasons, to address distributional problems, or to promote social and economic goals -- will result in more complicated tax calculations, higher tax rates overall, and reduced efficiency gains. In addition, the transition could take many years to complete, and could be very costly and complex. Absent special transition rules, the move to a consumption tax could create many unintended winners and losers. New savers would be advantaged relative to those who saved in the past, including many of the elderly. Businesses that invest after enactment of the consumption tax would have a competitive advantage over businesses that invested just prior to the change. Rules could be designed to address these situations, but they would be complex and could lead to significant reductions in the economic benefits expected from a switch to a consumption tax.

We commend efforts to develop consumption tax proposals that are progressive and revenue-neutral. We recognize that the details of some of the recent tax reform proposals have not yet been provided, and that the details will affect the analysis of any particular proposal. However, we believe that completely replacing the income tax with a consumption tax ultimately could be excessively complex and could create economic disruption. Moreover, while there has been substantial international experience with credit-invoice VATs and broad familiarity within the United States with State retail sales taxes, adopting a form of consumption tax other than a credit-invoice VAT or national RST would be venturing into the unknown. We can only speculate as to how a consumption tax collected at the individual taxpayer level would work. There is no experience upon which to gauge its effects on the U.S. economy or its administrative and compliance costs, and no way to anticipate all the potential tax avoidance schemes that could be designed to exploit the new tax rules.

Other countries have typically introduced consumption taxes, not as replacements for progressive income taxes, but in place of existing distorting sales or turnover taxes. Most of our trading partners now rely on a mixed tax system that combines income and consumption taxes. Consequently, a wholesale replacement of the income tax with a consumption tax would represent a grand international experiment. The burden lies with the proponents of consumption taxes to show that it is worthwhile to conduct this experiment on the world's largest and most complex economy.

Mr. Chairman, the Administration is keenly aware of growing taxpayer frustration with the complexity of the income tax system, and we think that greater weight should be given to simplification in evaluating tax reform proposals than has been given in the past. A simpler tax system would have lower compliance costs for individuals and businesses and lower administrative costs for the government. Moreover, while the debate is in process, simplification should be given greater weight in evaluating any changes to our existing tax law. In this regard, we note that last year's House of Representatives passed H.R. 3419, the Simplification and Technical Corrections Act of 1994. We urge the Committee to consider this legislation again on an expedited basis. We look forward to working with the Congress on these and other initiatives to improve our tax system. While continuing to work to improve our current income tax, we will give serious consideration to broader reform proposals that meet the tax policy objectives set forth above -- proposals that would simplify the tax system and improve economic incentives without sacrificing revenue or fairness.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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June 7, 1995

**STATEMENT OF JOHN D. HAWKE, JR.
NOMINEE FOR
UNDER SECRETARY FOR DOMESTIC FINANCE
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS**

Mr. Chairman, Senator Sarbanes, and members of the Committee, I am deeply honored to appear before the Committee today. I especially want to thank you, Chairman D'Amato, for allowing me to appear before the Committee so promptly, and I appreciate the graciousness that you and Senator Sarbanes extended in letting me visit with you yesterday.

The prospect of serving in President Clinton's Administration is enormously exciting and challenging, as is the prospect of participating in the important work of this distinguished Committee, whose activities I have followed for more than 30 years. I have had the great pleasure of getting to know many of the members of the Committee's staff on both sides of the aisle over the years, and I have the highest professional and personal regard for them. I am particularly grateful to Secretary Rubin and Deputy Secretary Newman for their strong support and for the confidence they have reposed in me. They have assembled a tremendously talented group of people at the Treasury Department, and it is my earnest hope that I will be able to make a contribution to their efforts.

While I have always considered myself a New Yorker -- having been born, brought up and educated there -- my professional life has been spent in Washington -- as a law clerk to a wonderful appellate judge, Judge E. Barrett Prettyman; as counsel to a House Education Subcommittee; as a practicing lawyer at Arnold & Porter, where I served as Chairman for eight years; as a teacher of law at Georgetown University; and as a banking regulator, in the position of General Counsel to the Federal Reserve Board under the chairmanship of Arthur Burns. Since my time at the Federal Reserve 20 years ago, it has been my hope that I would be able some day to return to government service, and I am profoundly grateful to the President for making this hope come true.

RR-354

I am especially pleased to have the opportunity to serve at the Department of the Treasury. Treasury is at the epicenter of some of the most critical issues our country confronts, and the Under Secretary for Domestic Finance will have important responsibilities with respect to many of these issues -- particularly those dealing with the health, efficiency and competitiveness of our system of financial institutions. We have before us not only the challenge of energizing the financial services system of the 21st Century, but also the imposing responsibility of assuring that American taxpayers will never again be called upon to shoulder the burden of losses suffered by that system.

While I have had the good fortune to be able to learn something of these issues during my career, I approach the challenge of the Under Secretary's position with great humility. Even a lifetime of experience cannot prepare one fully to deal with the subtleties and complexities of the issues on our agenda today.

I can pledge to the Committee, however, that I will devote my full energies to the task, and I look forward to working with this and other committees of the Congress as we jointly try to serve the public's interest in finding effective means of dealing with these issues.

I would be pleased to respond to any questions the Committee may have.

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FOR IMMEDIATE RELEASE
June 7, 1995

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TREASURY OFFERS FOREIGN TAXPAYER I.D. PROPOSAL

The Treasury Department today proposed regulations that would require U.S. tax returns filed by foreign individuals with the Internal Revenue Service after December 31, 1995 to include taxpayer identification numbers.

"The goal of the new regulations is to ensure compliance with federal income tax laws," said Assistant Treasury Secretary for Tax Policy Leslie Samuels. In addition to the new requirement, the regulations tell foreign taxpayers how they can obtain taxpayer identification numbers.

These proposed rules will have no impact on current withholding tax rules. Rather, they would solve a long-standing problem of some foreign taxpayers having trouble getting tax identification numbers for their U.S. tax returns. The new identification number requirement also should speed up processing of tax returns filed by foreign individuals after December 31, 1995.

The proposals do not apply to information reporting documents, such as Form W-8. Treasury is considering streamlining current tax regulations regarding withholding tax on interest and dividend payments to foreign investors. Options for proving eligibility for the benefits of favorable tax rules and treaty benefits may include, but will not mandate, identification numbers.

"Both the proposed regulations and the review of current tax withholding rules are designed to encourage compliance with federal law and reduce unnecessary paperwork without disrupting financial markets," Samuels said.

Copies of the proposed regulations may be obtained by writing the Internal

(MORE)

RR-355

Revenue Service Freedom of Information Reading Room at P.O. Box 388, Ben Franklin Station, Washington, D.C. 20044, or by calling (202) 622-5164. Copies may also be obtained by writing the Office of Public Affairs, U.S. Treasury Department, Room 2315, Washington, D.C. 20220, or by calling (202) 622-2960.

-30-

The United States Mint

Mint News

From the Office of Public Affairs Washington, D.C. 20220

FOR IMMEDIATE RELEASE
JUNE 7, 1995

FOR FURTHER INFORMATION:
MICHAEL WHITE (202) 874-3134

MINT ANNOUNCES 1995 PROOF EAGLE SALES

- 60% of Limited-Edition 4-Coin Sets Already Sold -
- 38% of Limited-Edition 10th Anniversary Set Already Sold -

Washington, D.C. -- The U.S. Mint today announced it has sold 60 percent of the 10,000 limited-edition four-coin 1995 Eagle Proof Sets and 38 percent of the 45,000 limited-edition five-coin 10th Anniversary Eagle Proof Sets since sales started on April 21.

As of June 6, the Mint had sold 6,027 four-coin sets containing one-ounce, half-ounce, quarter-ounce and tenth-ounce Proof Gold Eagles. Actual sales of the 10th Anniversary Set, which contains the four gold coins plus a Proof Silver Eagle bearing a West Point mint mark, were 16,948.

Revenue from actual sales exceeded $32.2 million on June 6, equaling 56 percent of total revenues from last year's Eagle proof program.

Shipments of four-coin sets began May 19 for delivery within five weeks. Customers can order and pay for the five-coin anniversary set now, but deliveries will start in the fall.

"With seven months remaining in the sales period, these results are very gratifying and stronger than we expected. They are an endorsement by our customers for changes we made to the Proof Eagle program this year," said Mint Director Philip N. Diehl.

Those changes included limiting mintages on four-coin sets and launching sales in April instead of fall, creating the limited-edition 10th Anniversary Set with the unique Silver Eagle and for the first time offering discounts to bulk purchasers of individual proof Eagles.

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RR-356

"We made these enhancements to the Proof Eagle program in response to customers' requests, and this is one of our most successful customer service initiatives so far," the director said, adding, "We're especially proud to have held the line on prices for proof sets while offering discounts for bulk buyers."

Price of the 1995 4-coin set remains at $999, unchanged since 1990, when Proof Eagle prices were reduced. The 10th Anniversary Set also is priced at $999.

Purchased singly, a one-ounce Proof Gold Eagle is $570, a half-ounce $285, a quarter-ounce $150 and a tenth-ounce $70. The one-ounce Proof Silver Eagle is $23. Proof Silver Eagles purchased singly will be struck in Philadelphia with the "P" mint mark. Only Silver Eagles in the anniversary set bear the "W" mint mark.

Through the first-ever bulk program for individual proof Eagles, the gold one-ounce coin costs $490 for orders of five coins or more, the gold half-ounce is $250 for five or more, the gold quarter-ounce is $135 for 10 or more and the gold tenth-ounce is $65 for 10 coins or more. Proof Silver Eagles are $19 when 25 or more are ordered.

Sales of 1995 Proof Gold Eagles end December 31. Proof Silver Eagles will be sold while supplies last. The Mint reserves the right to limit quantities and to cease accepting orders. Coins might be delivered in multiple shipments at different times.

Actual Eagle sales by option as of June 6 were:

	Total Mintage	Bulk Coins Purchased	Total Coins Sold
Gold One-Ounce	70,000	46	3,728
Gold Half-Ounce	65,000	20	3,335
Gold Quarter-Ounce	70,000	115	4,049
Gold Tenth-Ounce	85,000	130	11,266
Silver One Ounce	500,000	13,241 (P)	215,096 (P)
Gold Four-Coin Set	10,000	Bulk Not Offered	6,027
10th Anniversary Set	45,000 (W)	Bulk Not Offered	16,948

Phone (800) 420-6300 to order Proof Eagles. For information about bulk purchases, call (202) 874-6323.

# # #

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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FOR DELIVERY AT 9:30 A.M.
June 8, 1995

ORAL STATEMENT OF
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Chairman Packwood and Members of the Committee:

I am pleased to have the opportunity today to discuss the scope and the purpose of the earned income tax credit (EITC), as well as steps that are being taken to improve the credit. While I will briefly touch upon compliance issues, Commissioner Richardson's testimony will address administrative matters more completely.

The Administration is strongly committed to the goals of the EITC, which are to make work pay and to lift workers out of poverty in the most efficient and administrable manner possible. With its message of "work pays," the EITC helps reduce dependency on welfare and increase reliance on jobs. This is why the EITC has been supported on a bipartisan basis during its 20-year history. During the 7-year period between 1986 and 1993, Congress voted to significantly expand the EITC in three major pieces of legislation under three Presidents -- the Tax Reform Act of 1986, OBRA 1990, and OBRA 1993. Both of the 1990 and 1993 expansions were deliberately phased in over a period of years by Congress.

The EITC provides tax relief to millions of working Americans, and that relief is not and has never been intended to be limited solely to federal income taxes. Under current law over 78 percent of EITC costs offset federal payroll and income taxes. Accordingly, it is inappropriate to evaluate the EITC solely under budget accounting conventions since those rules ignore payroll, excise, and other tax burdens borne by low-income workers.

Reductions in the EITC increase the tax burdens of low- and middle-income taxpayers and reduces the EITC's incentives to work. Under the Senate budget resolution, the EITC would be reduced, and tax burdens increased, for over 14 million working families. Working families with two or more children would be hit the hardest, with an average tax increase of $305 per year.

During the past several months, some observers have suggested that the EITC is growing uncontrollably. To the contrary, the increases in the EITC have resulted from carefully considered actions by Congress to gradually phase in the 1990 and 1993 expansions over a period of years. Once the 1993 expansion is fully phased in in 1996, future growth will be slightly less than projected growth of GDP.

We share the concerns of those members of this Committee and others who are troubled by the error rates associated with the EITC, just as we are troubled by error rates in other areas that contribute to the overall tax gap. This Administration is strongly committed to reducing both inadvertent taxpayer errors and the less common, but more troubling, fraud. We welcome the opportunity to work further with this Committee to address these areas. However, the only EITC compliance proposals that we understand are being considered are those that are contained in the President's budget. Significant reductions of the EITC, such as those contemplated in the Senate budget resolution, do not address compliance matters in any other way. In fact, those would actually result in increases in both work disincentives and, because of the complexity in certain proposals, non-compliance.

The Administration's commitment to improving the EITC for low-income working families has been demonstrated through more than a dozen legislative and administrative actions since early 1993. In taking these actions, we have been guided by the following four key goals:

(1) to make work pay for those who might otherwise be on welfare;

(2) to ensure that an individual who works full time throughout the year will not live in poverty;

(3) to target benefits to those with the greatest needs while minimizing distortions; and

(4) to make it easier for eligible individuals to claim the credit and for the IRS to verify their eligibility.

As the design of the EITC under current law reflects a balance among these four goals, I would like to address each of them individually.

First, for low-income families, the EITC makes work pay in two ways. Unlike many other assistance programs for low-income families, the EITC is limited to working families. Moreover, the credit amount initially increases -- rather than decreases -- for each additional dollar of earnings.

The positive link between the EITC and work can help offset the work disincentives created by other tax and transfer programs, such as social security taxes and food stamp benefits. The EITC, with its positive credit rate on low earnings, is the only program designed to help offset the marginal tax rates imposed by these other programs.

A second goal is to ensure that a person who works at a full-time job for the entire year will not live in poverty. In order to ensure that a family of four dependent on a full-time worker earning the minimum wage is lifted out of poverty, it would require a combination of food stamps, enactment of the President's proposal to increase the minimum wage, and effective implementation of the expanded EITC.

Third, the benefits of the EITC should be targeted to families with the greatest needs and to those who can be best served by the positive incentives associated with the EITC. The credit rate is highest at very low earning levels where individuals are often making the critical step from welfare to work. Because larger families have greater needs than smaller families, taxpayers with two or more children are entitled to a larger EITC than taxpayers with one or no children. Also, by providing the EITC to families with incomes of up to $28,524 in 1996, the program provides modest relief from the effects of wage stagnation.

The fourth goal of the EITC is simplicity and verification. If eligibility rules are simple, taxpayers can more accurately claim the EITC and avoid costly errors. With simple and verifiable eligibility rules, the IRS can also better ensure that the EITC is paid only to taxpayers who are eligible for the credit. Consequently, simplification should be given great weight in evaluating any proposal.

Legislative and Administrative Actions

As I mentioned, the Administration and Congress have taken a number of important legislative and administrative actions during the past two years to improve the effectiveness and administration of the EITC. For example, OBRA 1993 expanded the EITC and makes the program more effective in achieving its policy objectives. Last year's Uruguay Round legislation contained four provisions to improve compliance as well as the targeting of the EITC to those with the greatest need. As Commissioner Richardson will explain in her testimony, the Administration has taken very significant steps to ensure that those who are not eligible for the EITC do not receive it.

FY 1996 Budget Proposals. The Administration included several proposals to improve the targeting and administration of the EITC in this year's budget submission. The Administration's proposal to deny the EITC to taxpayers having more than $2,500 of taxable interest and dividends was included, in modified form, in H.R. 831. Under a second budget proposal, only individuals who are authorized to work in the United States would be eligible for the EITC beginning in 1996. Taxpayers claiming the EITC would be required to provide a valid social security number for themselves, their spouses, and their qualifying children. Social security numbers would have to be valid for employment purposes in the United States.

Our third proposal would authorize the IRS to use simplified procedures to resolve questions about the validity of a social security number. Under this approach, taxpayers would have 60 days in which they could either provide a correct social security number or request that the IRS follow the current-law deficiency procedures. If a taxpayer failed to respond within this period, he or she would be required to refile with correct social security numbers in order to obtain the EITC.

Demonstration Project Proposal. Last year the Administration proposed that States be given additional flexibility with respect to the EITC by allowing four demonstration projects to determine the effects of alternative methods of delivering advance payments of the EITC. We continue to support this important project.

Other Legislative Proposals

The Administration evaluates other proposals to modify the EITC by the same criteria we apply to our own proposals. We are concerned that many of the options that may be considered by this Committee will not meet these criteria. The affects of the two proposals described below are shown on the attached Table and Graph.

Senate Budget Resolution

The Senate budget resolution assumes that savings can be achieved by (1) repealing the EITC for workers without qualifying children, (2) scaling back the increases for families with children, and (3) adopting the Administration's EITC compliance proposals from the FY 1996 budget. According to our estimates, the EITC proposals in the Senate budget resolution would reduce the EITC by $16.6 billion over the next five years and $25.6 billion over the next seven years.

These proposals would limit the effectiveness of the EITC in reducing poverty generally and in encouraging work. We estimate that 14 million working Americans would be adversely affected. EITC recipients with two or more children would lose, on average, $305 in 1996. Very low-wage workers with only one child would lose, on average, $137 relative to current law.

The budget resolution also assumes the repeal of the EITC for 4.4 million very low-wage workers who do not reside with qualifying children. The EITC for these workers was designed to help offset the work disincentive effects of the social security tax. Under the resolution, these 4.4 million low-wage workers would loose eligibility for an EITC up to $324 and would incur, on average, a tax increase of about $173 in 1996.

The Senate budget committee resolution claims to address the problems of fraud and abuse and exploding costs in the EITC program. But EITC costs are not exploding and the only true compliance provisions are those included in the Administration's budget.

Welfare Reform Amendment

During the recent deliberations on welfare reform in this Committee, a possible amendment was circulated that would reduce the EITC far more deeply than budget resolution. Under the amendment, indexation of the EITC would be repealed. Indexation is necessary to ensure that taxpayers do not lose eligibility for the EITC. Under current law, an estimated 16.7 million taxpayers with children will claim the EITC in 1996. If benefit thresholds are not adjusted for inflation, participation would shrink to 14.8 million by 2000.

Eliminating indexation does not address the issue of fraud and abuse. Rather, it denies eligibility for the EITC to millions of law-abiding working taxpayers and reduces the benefits of millions of others who are playing by the rules. It is inappropriate to suspend indexation on the one provision which is solely targeted to low-income taxpayers. Consequently, the Administration strongly opposes proposals to eliminate indexation.

The amendment would also limit eligibility for the EITC by adding new restrictions on the amounts and types of income held by recipients. For example, the investment income cap would be lowered from $2,350 to $1,000. We have serious reservations about this proposal. Low and moderate-income families should be encouraged to save for down-payments on homes, start-up capital for businesses of their own, their children's education or their own retraining.

The amendment would also restrict eligibility for the EITC by expanding the definition of income to include non-taxable social security benefits, child support payments, non-taxable pension income, and tax-exempt interest. We would have serious concerns about imposing an additional tax on social security benefits of taxpayers who qualify for the EITC. Low-income elderly workers with children could be subject to higher taxes on social security benefits than some of their better-off neighbors. The proposal could affect non-elderly workers with young children, too. The EITC would be reduced or eliminated for a low-wage worker whose disabled spouse receives disability insurance benefits.

The tax system does not count child support as income to the custodial parent because child support payments are a continuation of the other parent's obligation to support his or her child. Custodial parents should be encouraged to seek child support, rather than being penalized for obtaining it. As a result, we have serious reservations about this provision as well. Moreover, this change would be extremely difficult for the IRS to administer because it does not currently receive information about child support payments.

The combined effect of these proposals, once fully phased in, would be to reduce the EITC for 19 million taxpayers by $602 on average. For 8 million taxpayers with two or more children, the EITC would be reduced, on average, by $886.

The Administration is committed to improving compliance with the EITC rules. Its actions in the last two years are clear evidence of this commitment. The compliance problems which the Administration is addressing should not be used as an excuse to eliminate or reduce the EITC benefits to millions of low-income working Americans.

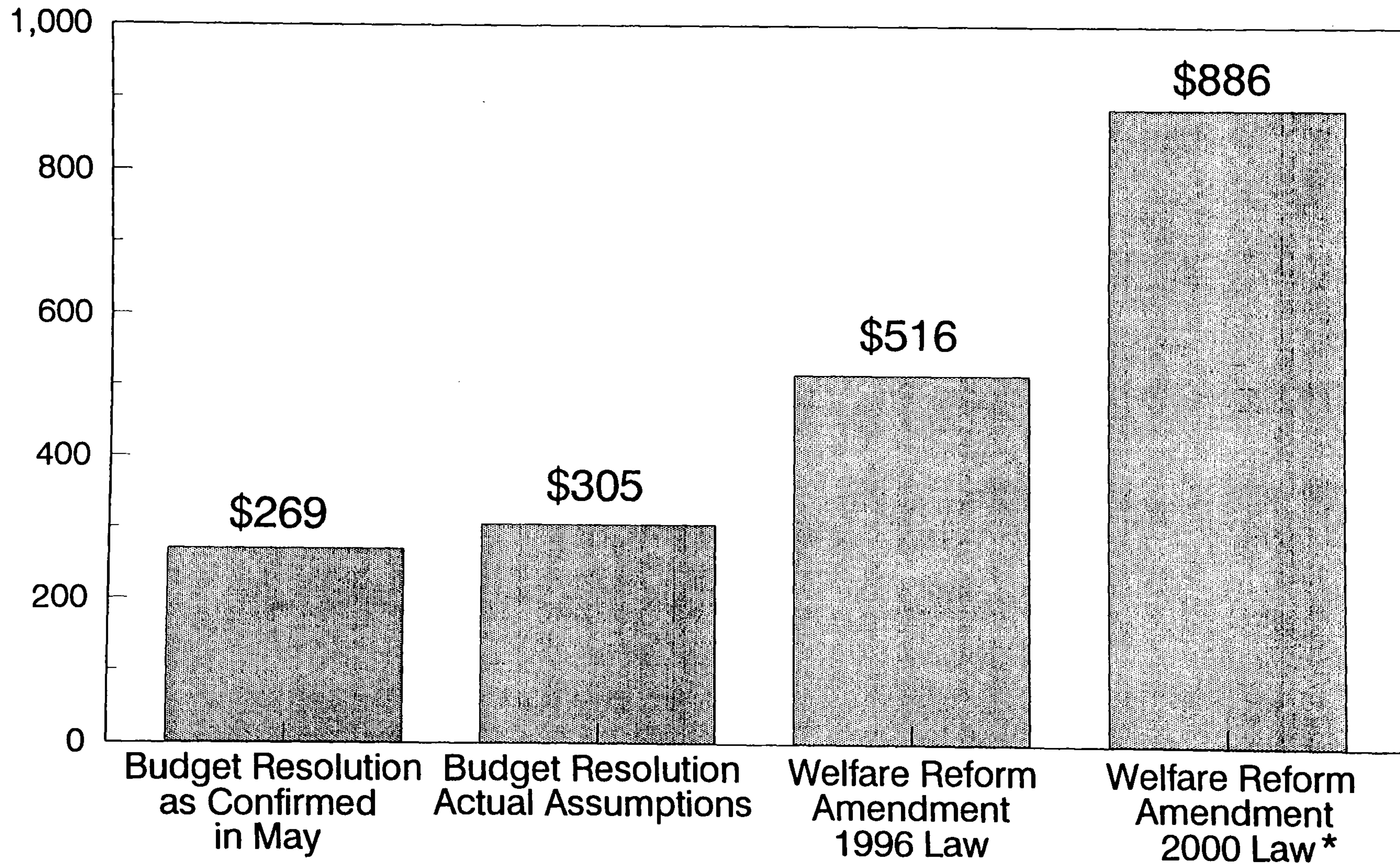
Finally, my written statement contains additional areas of possible improvement we would like explore with the Committee.

* * * *

This concludes my remarks. Thank you once again for providing me with the opportunity to testify. I would be pleased to answer any questions that the Committee may have.

Average Tax Increase for Taxpayers with Two or More Children

1996 Dollars



* Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

Average EITC Tax Increases
1996 Income Levels

	Budget Resolution		Welfare Reform Amendment	
	Confirmed assumptions in May	Actual assumptions	1996 Law	2000 Law*
Total EITC Recipients				
Number of Affected Taxpayers	12 million	14 million	19 million	19 million
Average Tax Increase	$235	$239	$311	$602
Taxpayers with Two or More Qualifying Children				
Number of Affected Taxpayers	8 million	8 million	8 million	8 million
Average Tax Increase	$269	$305	$516	$886
Taxpayers with One Qualifying Child				
Number of Affected Taxpayers	0	2 million	7 million	7 million
Average Tax Increase	$0	$137	$166	$563
Taxpayers without Qualifying Child				
Number of Affected Taxpayers	4 Million	4 Million	4 Million	4 Million
Average Tax Increase	$173	$173	$173	$173

Department of the Treasury
Office of Tax Analysis

June 7, 1995

Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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FOR RELEASE AT 9:30 A.M.
June 8, 1995

STATEMENT OF
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Chairman Packwood and Members of the Committee:

I am pleased to have the opportunity to discuss the scope and the purpose of the earned income tax credit (EITC), as well as steps that are being taken to improve the credit. While I will briefly touch upon compliance issues, Commissioner Richardson's testimony will address administrative matters more completely.

The Administration is strongly committed to the goals of the EITC which are to make work pay and to lift workers out of poverty in the most efficient and administrable manner possible. Since Senator Russell Long helped create the EITC in 1975, bipartisan support for the program and its goals has been growing. With its message of "work pays," the EITC helps reduce dependency on welfare and increase reliance on jobs. Prior to 1993, Congress voted to significantly expand the EITC in the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1990.

This Administration's commitment to the EITC has been demonstrated through a number of legislative and administrative actions since early 1993. In February 1993, we proposed an expansion of the EITC in order to improve its effectiveness in encouraging work and increasing the disposable income of working families. With certain modifications, Congress enacted the Administration's proposals as part of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993). The EITC is growing as it was designed to grow pursuant to the three expansions signed into law by Presidents Reagan, Bush, and Clinton respectively. As soon as those expansions are fully phased in, the EITC costs will grow at a slower rate than gross domestic product (Figure 1).

Since the passage of OBRA 1993, we have proposed further legislative changes to

improve the administration and targeting of the EITC, while reducing the costs of the program. Four of these proposals were included in the Uruguay Round Agreement Act of 1994 (URAA). As a consequence of that legislation, the EITC is denied to nonresident aliens and prisoners, taxpayers are required to provide a taxpayer identification number for each EITC qualifying child regardless of age, and the Department of Defense is required to report to both the IRS and military personnel the non-taxable earned income used in computing the EITC.

In this year's budget, we proposed that the EITC be denied to taxpayers with $2,500 or more of interest and dividend income. A similar, but modified, provision was included in H.R. 831, which extended and expanded the 25 percent deduction for health insurance costs incurred by self-employed individuals.

We have also made several proposals which are still pending final legislative action. This year's budget includes proposals to deny the EITC to undocumented workers and to provide the IRS with the authority to use simpler and more efficient procedures when taxpayers fail to supply a valid social security number. In addition, the Administration proposed legislation last year that would permit demonstration projects to test alternative methods of administering advance payments of the EITC. We hope that Congress will act on these outstanding proposals.

As Commissioner Richardson will testify, the Administration has taken other significant actions to strengthen the integrity of the EITC. We have expanded our outreach efforts to ensure that eligible low-income individuals are aware of the EITC and the advance payment option. We have also conducted studies of EITC compliance and the broader issue of problematic refunds. Last spring, then-Secretary Bentsen appointed a Task Force to conduct an independent investigation of the refund fraud, and Under Secretary Noble presented their interim findings and call for aggressive action to the Ways and Means Oversight Subcommittee last October. This year, we have intensified our scrutiny of returns claiming the EITC in order to prevent erroneous refunds from being paid to ineligible individuals.

We understand that members of this Committee are concerned about non-compliance and are also considering ways in which the EITC could be redesigned to reduce the cost of the credit to the Federal government. However, in recent weeks we have become quite concerned about how the goals and purpose of the EITC have been mischaracterized. Moreover, many proposals that have been discussed to change the EITC, though described as compliance measures, would not reduce error rates. Rather, these proposals would simply increase the tax burden on low and moderate-income working families. In fact, some alternative proposals to redesign the EITC would actually cause both non-compliance and work disincentives to increase. Finally, before considering significant changes to this important work incentive, we would urge the Congress to wait until we have had time to observe the effects of both recent legislation and our enhanced compliance efforts.

In the remainder of my testimony, I will discuss in some detail the goals of the EITC and the actions taken by the Administration to strengthen the effectiveness of the EITC, as well as our views regarding proposals for possible modifications to the EITC.

Description of Earned Income Tax Credit for Low-Income Workers

The EITC is a refundable tax credit that is available only to low and moderate income workers who have earned income and meet certain adjusted gross income (AGI) thresholds. To be eligible for the EITC, a taxpayer must reside in the United States for over six months. Nonresident aliens are not entitled to the EITC beginning in 1995.

The amount of the credit increases significantly if an individual has one or two qualifying children. A child qualifies a filer for a larger EITC by meeting relationship, residency, and age tests. To meet the relationship test, the individual must be a child, stepchild, descendent of a child, or foster child of the taxpayer. The child must generally reside with the taxpayer in the United States for over half the year. For foster children, the residency test is extended to the full year. A qualifying child must be under the age of 19 (24 if a full-time student) or be permanently and totally disabled. By tax year 1997, a taxpayer must provide a taxpayer identification number (TIN) for each qualifying child.

Computation of the Credit. The credit is determined by multiplying an individual's earned income by a credit percentage. For a family with only one qualifying child, the credit percentage for 1995 is 34 percent. The credit amount increases as income increases, up to a maximum income threshold. For 1995, the income threshold is $6,160. Therefore, if there is only one qualifying child, the maximum credit for 1995 is $2,094 (34 percent of $6,160).

The credit is reduced and eventually phased out once AGI (or, if greater, earned income) exceeds a certain phase-out threshold. For 1995, the phase-out threshold is $11,290. The phase-out is accomplished by reducing the credit by a phase-out percentage. In 1995, for a family with only one qualifying child, the credit is reduced by an amount equal to 15.98 percent of the excess of AGI (or, if greater, earned income) over $11,290. The credit is completely phased out and is no longer available to taxpayers with incomes above the end of the phase-out range. In 1995, this income level is $24,396. The income thresholds for both the phase-in and phase-out ranges are adjusted for changes in the cost of living.

If there are two or more qualifying children, the credit percentage, income thresholds, and phase-out percentage are higher. For 1995, the credit percentage for families with two or more children is 36 percent of the first $8,640 of earned income. Filers with earnings between $8,640 and $11,290 are entitled to the maximum credit of $3,110 (36 percent of $8,640).

The phase-out percentage for these families is 20.22 percent. As in the case of the credit for families with one child, the credit is phased out starting at $11,290. However, the phase-out range for families with two or more children extends to $26,673.

In 1996, the credit percentage for families with two or more children will increase to 40 percent of the first $8,900 of earnings. Filers with earnings between $8,900 and $11,620 will

be entitled to the maximum credit of $3,560 (40 percent of $8,900). The phase-out percentage will also increase to 21.06 percent, and the phase-out range will extend to $28,524. Thereafter, the income thresholds for both the phase-in and phase-out ranges will be adjusted for changes in the cost of living. (The dollar amounts shown for 1996 are estimates.)

Workers who do not reside with qualifying children may claim the EITC if they are between 25 and 64 years of age and are not claimed as a dependent on another taxpayer's return. For these workers, the basic credit is 7.65 percent of the first $4,100 of earned income for a maximum credit of $314. In 1995, the phase-out range for these workers is between $5,130 and $9,230 of AGI (or, if greater, earned income). The phase-out percentage is also 7.65 percent. The income thresholds for both the phase-in and phase-out ranges are adjusted for changes in the cost of living.

Figures 2 and 3 show the EITC credit structure for 1995 and 1996, respectively.

Advance Payments of the EITC. There are two ways to receive the EITC. Individuals can claim the credit by completing a Schedule EIC when filing their tax return at the end of the year. Alternatively, individuals with qualifying children may elect to receive a portion of their EITC in advance by filing a Form W-5 with their employer. These individuals are entitled to receive on an advance basis up to 60 percent of the credit allowable for a family with one qualifying child. The employer is not required to verify a person's eligibility for the credit.

At the end of the year, the employer notifies both the IRS and workers of the actual amounts of advance credits paid to individual workers on the Form W-2. When filing tax returns at the end of the year, these workers reduce the amount of EITC claimed by the amount of advance payments received.

Questionable Claims: The IRS must follow normal deficiency procedures when investigating questionable EITC claims. First, contact letters requesting additional information are sent to the taxpayer. If the necessary information is not provided by the taxpayer, a statutory notice of deficiency is sent by certified mail, notifying the taxpayer that the adjustment will be assessed unless the taxpayer files a petition in Tax Court within 90 days. If a petition is not filed within that time and there is no other response to the statutory notice, an assessment is made in which the EITC is denied.

Refundable Nature of Credit: The EITC offsets Federal taxes paid by low and moderate-income families. In recent discussions, there has been some confusion regarding the refundable nature of the EITC. In large part, this confusion appears to stem from the distinction between Congressional intent and budgeting conventions. Under conventional budget accounting practices, the EITC is shown in the budget as a reduction in taxes only to the extent to which it offsets a taxpayer's liability for taxes paid through the income tax system. This is because the EITC is claimed through the income tax system and as a practical matter, the credit can be most easily measured as an offset against the taxes paid through this system. Thus, under these conventions, about 23 percent of EITC costs in FY 1995 are shown in the budget as a reduction

in Federal income taxes and other taxes paid through the income system, including self-employment taxes (SECA). About half of EITC recipients have an income or SECA tax liability prior to the receipt of the EITC.

Given that the EITC is created to offset the tax burden of low and moderate-income families, the EITC should not simply be measured as an offset to income and SECA taxes. When the reduction in the employee and employer portions of all social security taxes are included in the calculation, about 78 percent of EITC costs offset individual income and payroll taxes paid by recipients. Nearly all EITC recipients are subject to either individual income or social security taxes before qualifying for the EITC. Even this measure does not take into account other taxes which are offset by the EITC. During the consideration of both OBRA 1990 and 1993, the EITC expansions were also viewed as a way of offsetting the burden of increases in excise taxes, particularly the increases in the gasoline tax.

There has also been some confusion about the fact that most EITC recipients choose to claim the credit at the end of the year as a lump-sum payment rather than by adjusting their withholding or by taking advantage of the advance payment option. In that regard, EITC recipients are not very different from the majority of taxpayers who choose to receive a refund at the end of the year, rather than reduce their income tax withholding during the year. About 70 percent of non-EITC recipients receive an average refund of $1,150 at the end of the year.

Goals of the EITC

In developing the Administration's agenda for the EITC, we have been guided by the three basic principles of tax policy: efficiency, fairness, and simplicity. Specifically, we have sought expansions and modifications to the EITC in order to achieve the following four goals:

(1) to make work pay for those who might otherwise be on welfare;
(2) to ensure that an individual who works full time throughout the year will not live in poverty;
(3) to target benefits to those with the greatest needs while minimizing distortions; and
(4) to make it easier for eligible individuals to claim the credit and for the IRS to verify their eligibility.

I would like to address each of these four goals in more detail.

For low-income families, the EITC makes work pay in two ways. Unlike many other assistance programs for low-income families, the EITC is limited to working families. Moreover, the credit amount initially increases -- rather than decreases -- for each additional dollar of earnings. As a consequence, the EITC is different from other low-income assistance programs that are characterized by a reduction in benefits for each additional dollar of earnings.

The EITC significantly increases the marginal return from working for both those who do not work at all and those who work less than full-time at minimum-wage jobs throughout the year.

The positive link between the EITC and work also helps offset the work disincentives created by other tax and transfer programs. Between 1983 and 1990, payroll taxes increased five times. Currently, workers are taxed at the combined employer and employee rates of 15.3 percent on the first dollar of earnings for the old-age, survivors, disability and health insurance (OASDHI) programs. Beyond a relatively low income threshold, food stamp benefits are reduced by 24 cents for each additional dollar of earnings. The EITC, with its positive credit rate on low earnings, is the only program designed to help offset the marginal tax rates imposed by these other programs.

A person who works at a full-time job for the entire year should not live in poverty. The Federal government assists low-income families in a number of ways. The Federal government requires employers to pay workers at least the minimum wage, and provides direct assistance to families through food stamp benefits and the EITC. In order to ensure that a family of four dependent on a full-time worker earning the minimum wage is lifted out of poverty, it would require a combination of food stamps, enactment of the President's proposal to increase the minimum wage, and implementation of the expanded EITC.

Earlier this year, Secretary Rubin visited a volunteer income tax assistance (VITA) site here in the District of Columbia. At the site, he met Rhonda Clark, a mother from Maryland. Talking of her experiences with the EITC, Ms. Clark said, "I enjoy working and I want to continue. The EIC gives me some of the help I need -- to keep working, to stay independent, and to support my family. It's a help I can not do without." Ms. Clark's experience provide a vivid example of how the EITC makes a difference in people's lives by encouraging them to work and providing them with additional assistance.

As the EITC has increased in recent years, the minimum wage and other benefits received by low-income working families have declined in real value. Without an increase in the minimum wage, its real value in 1996 will decline to its lowest value in forty years. In addition, AFDC benefits are no longer provided for most families in which a mother works at least half-time. In the early 1970s, most states provided AFDC benefits as a wage supplement to a mother with two children whose earnings equaled 75 percent of the poverty level. Currently, only three states provide comparable benefits. The EITC expansions have been necessary to at least partially offset the reductions in the real value of the minimum wage and other Federal benefits.

The benefits of the EITC should be targeted to families with the greatest needs and to those who can be best served by the positive incentives associated with the EITC. As a consequence, the credit rate is highest at very low earning levels, thus reaching individuals who are often making the critical step from welfare to work. Because larger families have greater needs than smaller families, taxpayers with two or more children are entitled to a larger EITC than taxpayers with one or no children.

Families with incomes slightly above the poverty level also require assistance. Wages have stagnated for many workers and declined markedly for low-wage workers. Between 1973 and 1993, real hourly wages of full-time male workers at the tenth percentile (that is, those whose wages are just above those of the lowest-paid 10 percent of workers) declined 16 percent, while real hourly wages at the median fell 12 percent. By providing the EITC to families with incomes of up to $28,524 in 1996, the program provides a cushion to protect moderate-income families from the effects of wage stagnation.

We recognize that the targeting of the EITC to the neediest workers could have unintended effects. First, the EITC increases the income of all recipients, allowing them to maintain their standard of living with less work effort. For very low-wage workers, these negative effects are largely offset by the fact that the credit also increases their after-tax wage rate and thus the pay-off to work. As incomes increase above $11,290, EITC benefits begin to phase-out. As a consequence, the marginal tax rates for families of modest means increase. Among recipients in the phase-out range, the EITC could cause some individuals, primarily the spouses of other workers, to reduce the number of hours worked in response to higher marginal tax rates.

In this regard, the EITC is similar to any benefit program which targets assistance to the very neediest families. We cannot target assistance to low-income families without causing marginal tax rates to increase for families with slightly higher income. However, we can seek to minimize such distortions.

The fourth goal of the EITC is simplicity and verification. If eligibility rules are simple, taxpayers can more accurately claim the EITC and avoid costly errors. With simple and verifiable eligibility rules, the IRS can also better ensure that the EITC is paid only to taxpayers who are eligible for the credit.

Simplicity is particularly important, because eligible individuals can claim the EITC directly when they file their tax return. It is likely that this simple application process has contributed to high participation rates in the program. It has been estimated that between 80 and 86 percent of eligible persons claimed the EITC in 1990.

From the IRS's perspective, it is easier to verify eligibility for the EITC if the rules are simple. Moreover, because the IRS does not ordinarily interview EITC claimants, it is important that eligibility be based on criteria which can be verified as quickly as possible through independent reporting sources. Simplicity and verification prior to the payment of the EITC are key to the successful operation of the program.

This Committee recognized the importance of the need for simplicity during consideration of OBRA 1990. At that time, data from the 1985 Taxpayer Compliance Measurement Program (TCMP) became available, showing an unacceptable number of erroneous EITC claims. In response, then-Chairman Bentsen requested that the Bush Administration work with the tax-writing committees to address this problem. The simplification provisions contained in OBRA

1990 were a first step toward reducing EITC error rates. As described below, additional steps have been taken since 1990 to further reduce EITC error rates.

Legislative and Administrative Actions in 1993 and 1994

As I outlined in the beginning of my testimony, the Administration and Congress have taken a number of important legislative and administrative actions during the past two years in order to improve the effectiveness and administration of the EITC. I would like to review with you our accomplishments during this period.

OBRA 1993. OBRA 1993 expands the EITC and makes the program more effective in achieving its policy objectives.

First, OBRA 1993 increased the returns from working for those outside the workforce and for other very low-wage workers. (See Figure 4.) For very low-wage workers without qualifying children, the EITC offsets the employee portion of the OASDHI tax. During the past decades, these workers had borne the full burden of increases in OASDHI taxes because they were not entitled to the EITC. For a family with one child, the credit rate for those with low earnings was increased by 11 percentage points from 23 percent to 34 percent. For a family with two or more children, the credit rate for those with earnings below $8,900 in 1996 was increased by 15 percentage points from 25 percent to 40 percent. For low-wage workers with two or more children, the EITC will fully offset the combined employee and employer portions of the OASDHI taxes and the food stamp benefit reduction formula.

The OBRA 1993 expansion was also a critical step toward achieving the goal that a full-time worker should not live in poverty if he or she works throughout the year. In combination, a minimum wage job, food stamp benefits, and the EITC can lift a single parent with one or two children out of poverty. But, the income (including the EITC and food stamps and subtracting the employee portion of OASDHI taxes) of a family of four with only one full-time, minimum wage worker falls below the official poverty threshold. Prior to the passage of OBRA 1993, the poverty gap for a family of four would have been $2,435 in 1996. The OBRA 1993 expansion significantly closes that gap. However, since the minimum wage has not kept pace with inflation, the job is not completed yet. This is why the President has proposed that the minimum wage be increased over two years by 90 cents.

OBRA 1993 reduced the poverty gap for minimum wage workers by increasing the maximum benefits by nearly $1,500 in 1996 for a family with two or more children. For these families, this increase in the maximum credit, without a change in the phase-out range, would have resulted in a phase-out rate of 30 percent. In OBRA 1993, we tried to find a balance between the goals of providing low-income families with sufficient income support, while minimizing the marginal tax rates placed on families with higher, but still modest, levels of income.

Thus, the increases in the maximum credit were accompanied by changes in the income

thresholds. For all families with children, the beginning of the phase-out range was lowered by about $1,600. As a consequence, the phase-out rate actually fell slightly for a family with one child since the end of the phase-out range was left unchanged. To reduce marginal tax rates among families in the phase-out range, eligibility for the EITC was extended to families with two or more children that have incomes in 1996 of up to $28,524 (or about $3,000 above the prior level). The combination of these factors increased the phase-out rate from 17.86 percent to 21.06 percent, rather than 30 percent.

While the effect of OBRA 1993 can not be measured yet, we believe that the legislation will, on net, increase work effort. While some workers with larger families will face slightly higher marginal tax rates, they are unlikely to change their behavior much in response. These are individuals who are already very attached to the work force. They cannot easily adjust their hours of work in response to a small change in tax rates; they need both their jobs and the EITC to meet their day-to-day needs, and most employers will not allow them the discretion to work fewer hours. The effect of the higher marginal tax rates on some workers in the phase-out range will likely be far outweighed by the effect of the increase in the credit rate. By making work pay, the OBRA 1993 increase in the credit rate will encourage non-workers to enter the workforce and other low-income part-time workers to increase their hours of work.

Finally, OBRA 1993 simplified the eligibility criteria for the EITC beginning in 1994 by eliminating the two supplemental credits for health insurance coverage and for taxpayers with children under 1 year of age. These two supplemental provisions added several paragraphs to the instructions, 10 additional lines on the Schedule EIC, and two additional look-up tables. The IRS could not easily verify eligibility for the supplemental credits because it did not receive independent verification of taxpayers' eligibility for them. These changes should improve compliance by reducing errors and improving verification.

URAA. URAA contains several provisions to improve the targeting of the EITC to those with the greatest need. Under this legislation, nonresident aliens are denied the EITC beginning in 1995. Under prior law, nonresident aliens could receive the EITC based on their earnings in the United States, even though they were not required to report their world-wide income to the IRS. Thus, it was possible for a wealthy foreign student to obtain the EITC based on his or her earnings as a teaching assistant at an American university.

In addition, prisoners will not be eligible for the EITC based on their earnings while incarcerated. In the past, prisoners generally would not have been able to claim the EITC because they did not reside with a qualifying child for over half the year. When the EITC was made available to workers without children in 1994, it became possible for prisoners to receive the EITC based on their earnings at prison jobs. Because this provision was made effective for tax year 1994, the EITC will not be paid to these individuals.

URAA also contained two provisions to improve the administration of the EITC. By 1997, taxpayers will be required to provide TINs for all dependents and EITC qualifying children, regardless of their age. By requiring EITC claimants to provide the TINs of all

children, regardless of age, URAA improves the ability of the IRS to verify the eligibility of a taxpayer for the EITC.

Under the legislation, the Department of Defense is required to provide military personnel and the IRS with information regarding basic housing and subsistence allowances (or in-kind equivalents) and income excluded by reason of service in a combat zone. These changes will not increase their taxable income but will improve accuracy in reporting and verification of earned income. The savings from this provision are somewhat offset by another provision which extends EITC eligibility to military personnel stationed abroad.

Administrative Actions. The Administration has taken a number of steps to ensure that eligible individuals know about the EITC and the advance payment option. While many eligible persons receive the EITC, fewer than 1 percent of EITC claimants receive the credit through advance payments. The reasons for the low utilization rate are not fully known. One possible explanation is that workers simply do not know that they have the option of claiming the credit in advance. A General Accounting Office study in 1992 provided some support for this theory when investigators found widespread ignorance about the advance payment option among low-income workers.[1]

The Administration has intensified its efforts to alert taxpayers of their eligibility for advanced payments. As one of the first steps, President Clinton announced a Federal campaign in 1994 to enroll eligible government workers in the advanced payment system. The Treasury Department and a group of business executives have also joined forces to encourage private-sector employers to notify their workers about the advanced payment option. As required by OBRA 1993, the IRS sends out notices to EITC claimants after the filing season, informing them about the advance payment option and (although not required by the 1993 legislation) also supplying a Form W-5 for their use.

As Commissioner Richardson will explain, the Administration has also taken steps to ensure that those who are not eligible for the EITC do not receive it. During a two-week period in January, 1994, the IRS conducted a pilot study to determine what additional enforcement tools might be necessary to detect and prevent erroneous refunds during the remainder of the 1994 filing season. The results of the pilot compliance study, drawn from a sample of over 1,000 taxpayers who filed electronically during a two-week period in January, 1994, found that about 26 percent of every dollar claimed in the EITC was in excess of the actual amount owed to the taxpayer.

The results of this pilot study are not representative of the EITC filing population as a whole. Nonetheless, the IRS has taken a number of responsible and needed steps to limit the EITC to those who are entitled to the credit. Beginning this year, the IRS is validating the

[1] U.S. General Accounting Office. Earned Income Tax Credit: Advance Payment Option is Not Widely Known or Understood by the Public. (GAO/GGD-92-26, February 19, 1992).

social security numbers on all tax returns claiming the EITC. Refunds on returns with incorrect or missing numbers are being delayed while the IRS checks the accuracy of the refunds claimed. We estimate that the effects of the social security validation tests, along with conventional enforcement activities and the repeal of the complicated supplemental credits, should reduce the error rate to 19 percent. Using the results of the pilot study and other information, the IRS is also increasing its screening and review of all returns to ensure that only those taxpayers entitled to refunds receive them. As a consequence, refunds may be delayed on other questionable returns. These additional enforcement procedures should further reduce erroneous payments of the EITC. Moreover, we anticipate that the error rates should be further reduced as a consequence of other legislative steps, described above, which are still being implemented over the next several years (e.g., the requirement that taxpayers provide a taxpayer identification number for all children regardless of age). Also, Congressional action on the Administration's remaining legislative proposals, described below, should further reduce error rates. In combination, implementation of these enforcement procedures will make it more difficult for taxpayers to erroneously claim the EITC.

Finally, the IRS stopped providing Direct Deposit Indicators in the 1995 filing season to lenders who were providing refund anticipation loans. This action is also expected to reduce compliance problems that were associated with refund anticipation loans. The IRS's actions this filing season have been applauded as both responsible and necessary by Ways and Means Oversight Subcommittee Chairman Johnson and Ranking Member Matsui in a recent "Dear Colleague" letter to House members.

FY 1996 Budget Proposals

The Administration included several proposals to improve the targeting and administration of the EITC in this year's budget submission. We are ready to work with the Congress on those proposals which have not yet been enacted.

Deny EITC to taxpayers having more than $2,500 of taxable interest and dividends. Under this proposal, the EITC would be denied to taxpayers having more than $2,500 of taxable interest and dividends beginning in 1996. This threshold would be indexed for inflation thereafter.

This proposal would improve the targeting of the EITC to the families with the greatest need. Under current law, a taxpayer may have relatively low earned income and be eligible for the EITC, even though he or she has significant interest and dividend income. Most EITC recipients do not have significant resources and must rely on their earnings in order to meet their day-to-day expenses, but taxpayers with significant interest and dividend income can draw upon the resources that produce this income to meet family needs.

This proposal, with some modification, was included in H.R. 831, which extended and expanded the 25 percent health insurance deduction for self-employed individuals. H.R. 831

lowered the asset income threshold to $2,350 and expanded the categories of income subject to the threshold to include tax-exempt interest and net positive rents and royalties. The asset income threshold is not indexed.

In developing the Administration's proposal, we considered a broader list of asset income subject to the cap. We recognized that a broader list might increase equity, by treating the recipients of certain other types of asset income in the same manner as those who receive interest and dividend income. An expanded list would also reduce the incentive to choose a particular type of investment based on its tax or refund consequences. However, we were also concerned because the inclusion of net positive rents and royalties would add complexity to the determination of the EITC. These items are not reported separately on the Form 1040. We did not include the broader list of asset items because we were also concerned that low-income taxpayers could not convert real estate holdings and other types of assets into cash as easily as savings accounts and stocks in a time of need.

While we did not oppose the inclusion of tax-exempt interest and net rents and royalties in H.R. 831, we are very concerned about the asset income threshold not being indexed. We believe that the asset income threshold should be indexed in the same manner as all other income parameters for the EITC. Without indexation, the number of persons affected by this provision will increase over time. By 2000, the threshold would be equal to about $2,075 in 1996 dollars and would increase the number of affected taxpayers from about 550,000 to 650,000.

EITC Compliance Proposals. Under this budget proposal, only individuals who are authorized to work in the United States would be eligible for the EITC beginning in 1996. Taxpayers claiming the EITC would be required to provide a valid social security number for themselves, their spouses, and their qualifying children. Social security numbers would have to be valid for employment purposes in the United States. Thus, eligible individuals would include U.S. citizens and lawful permanent residents. Taxpayers residing in the United States illegally would not be eligible for the credit.

In addition, the IRS would be authorized to use simplified procedures to resolve questions about the validity of a social security number. Under this approach, taxpayers would have 60 days in which they could either provide a correct social security number or request that the IRS follow the current-law deficiency procedures. If a taxpayer failed to respond within this period, he or she would be required to refile with correct social security numbers in order to obtain the EITC.

In combination, these provisions would strengthen the IRS's ability to detect and prevent erroneous refunds from being paid out. In addition, the proposals would improve the targeting of the EITC by providing the credit only to individuals who were authorized to work in the United States.

Tax Systems Modernization. The budget submission for the IRS contains funding for the continuation of its tax systems modernization (TSM). We urge the Congress to continue to fund

TSM. TSM is vital to the long-run efficiency of the IRS's collection functions. TSM will also enhance the IRS's ability to detect erroneous EITC claims.

Demonstration Projects Proposal

In June 1994, the Administration introduced the Work and Responsibility Act (H.R. 4605). One of the provisions in H.R. 4605 would provide additional flexibility to States with respect to the EITC. We continue to support this proposal.

The proposal would allow four demonstration projects to determine the effects of alternative methods of delivering advance payments of the EITC. States would apply to the Department of the Treasury to provide advance payments of the EITC directly to eligible residents through a State agency. Such agencies could include food stamp offices, Employment Services, and State revenue departments. State plans would be required to specify how payment of the EITC would be administered. To finance these payments, States would reduce payments of withholding taxes (for both income and payroll taxes) from their own employees by the amount of the advance payments made during the prior quarter. The four selected projects could operate for three years beginning in 1996.

This pilot program is designed to determine whether another approach would be more effective for delivering advance payments than the current employer-based system. For example, a State could choose to allow all eligible EITC recipients to apply for advance payments. By receiving the credit as they earn wages, workers would observe the direct link between work effort and the EITC. Through a State program, individuals could have a choice of receiving the credit from a neutral third-party, without fear of the consequences of notifying their employers of their eligibility for the EITC. Moreover, they could receive assistance in determining the appropriate amount of the EITC to claim in advance.

A State could instead choose to target the advance payments of the EITC to welfare recipients -- as a way of driving home the message that "work pays." These individuals may not know about the EITC, and how it can "make work pay," because they do not have to file a tax return if their adjusted gross incomes are below the tax thresholds (which are generally less than the poverty thresholds).

If the legislation passes, we will evaluate these demonstration projects in order to understand better how individuals respond to receiving advance payments of the EITC. We will pay careful attention to whether the use of State agencies can increase both utilization of the advance payment system and labor force participation by non-workers.

States also have the resources to verify many of the eligibility criteria for the credit better than employers, reducing the risk of erroneous payments being made to ineligible persons. This option would also allow for an evaluation of alternative delivery systems on compliance.

Other Suggestions

The Administration evaluates other proposals to modify the EITC by the same criteria we apply to our own proposals:

(1) Does the proposal make work more attractive to those outside the workforce and to others with minimal ties to the workforce?
(2) Does the proposal reduce the poverty gap for full-time workers?
(3) Does the proposal improve the targeting of the EITC to the neediest individuals and families in the least distortionary manner? and
(4) Does the proposal make it easier for eligible taxpayers to accurately claim the EITC and for the IRS to verify their eligibility before refunds are paid out?

We are concerned that many of the options that may be considered by this Committee do not meet these criteria.

1. Senate Budget Committee Resolution

The Senate budget resolution assumes that this Committee will reduce the EITC by $13 billion between FY 1996 and 2000 and $21 billion between FY 1996 and 2002. The resolution further assumes that these savings can be achieved by repealing the EITC for workers without qualifying children, limiting the increases for families with children, and adopting the Administration's EITC compliance proposals from the FY 1996 budget. During the Budget Committee's deliberations on the budget resolution, we believed that the resolution assumed the repeal of the final phase of the OBRA 1993 expansion, which is scheduled to occur on January 1, 1996. As a consequence, the credit rate for families with two or more children would be frozen at 36 percent instead of 40 percent.

During the floor debate on the budget resolution by the Senate, we learned that the reductions in the EITC are deeper than had been earlier thought. The budget resolution does not merely limit the increases for families with children. Instead, it reduces the EITC for many families below the 1995 levels. Under the resolution, the credit rate for a family with two or more children would be reduced from its 1995 level of 36 percent to 35 percent. In addition, the credit rate for families with one child would be reduced from 34 percent to 30.15 percent. According to Treasury's estimates, the EITC proposals in the Senate budget resolution would reduce the EITC by $16.6 billion over the next five years and $25.6 billion over the next seven years.

These proposals would generally limit the effectiveness of the EITC in reducing poverty. For example, in 1996, the maximum EITC for families with two or more children is scheduled to increase from $3,110 to $3,560. This is the level necessary, in combination with a 90 cent increase in the minimum wage, to close the poverty gap for a full-time minimum wage worker who supports a family of four. Under the Senate budget resolution, the maximum credit would be $445 less than current law.

By lowering the credit rate for families with children, the proposal also reduces the effectiveness of the credit for encouraging work effort. Under the proposal, many EITC recipients with earnings of less than $8,900 could receive a smaller EITC than in 1995. The reductions in the credit rate would also adversely affect those who are currently outside the workforce, but who are choosing between work and welfare.

The Treasury Department estimates that 14 million EITC recipients would be adversely affected by the proposals. Of these 14 million, 10 million workers and their families would be adversely affected by the proposed reductions in the credit for families with children. About 8 million EITC recipients with two or more children would lose, on average, $305 in 1996. About 2 million very low-wage workers with only one child would lose, on average, $137 relative to current law. (See Figure 5 and attached table.)

The budget resolution also assumes the repeal of the EITC for 4 million very low-wage workers who do not reside with qualifying children. The OBRA 1993 expansion of the EITC for these workers was designed to help offset the work disincentive effects of the social security tax. If repealed, these workers will lose up to $324 in 1996. At the poverty level ($7,710 in 1996), a single taxpayer would have a combined income and social security tax liability of $1,350 (including $170 of income tax liability prior to the receipt of the EITC). Under the proposal, the taxpayer's tax liability would increase by $138. On average, low-wage workers who do not reside with qualifying children would incur a tax increase of about $173 in 1996.

The Senate budget committee resolution claims to address the problems of fraud and abuse and exploding costs in the EITC program. But EITC costs are not exploding. After OBRA 1993 is fully implemented in 1996, EITC costs will increase in tandem with inflation and population growth. Moreover, the resolution contains only one proposal to address fraud and abuse: the Administration's proposal to deny the EITC to undocumented workers and to provide the IRS with the authority to use simpler and more cost-effective procedures when taxpayers fail to provide valid social security numbers. Instead, the Senate budget resolution would reduce the EITC for 14 million working families, on average, by about $239.

2. Welfare Reform Amendment

During the recent deliberations on welfare reform in this Committee, an amendment to reduce the EITC was circulated. (This amendment was ruled as non-germane under Committee rules, along with other tax amendments.) Copies of the amendment were made available at the time of the mark-up, and we would like to take the opportunity to comment on the proposals. This amendment adopts most of the proposals assumed in the Senate budget resolution. However, it would reduce the EITC far more deeply than was considered in the resolution. According to Treasury estimates, the amendment would reduce the EITC by $37 billion between FY 1996 and 2000 and $66 billion between FY 1996 and 2002.

Under the amendment, indexation of the EITC would be repealed. As a consequence, EITC recipients would be entitled to a maximum benefit of $3,024 in 1996, a reduction of $536

relative to current law. The maximum benefit amount would not change after 1996. By 2000, the maximum credit amount would be reduced by $1,016 -- or 25 percent -- relative to current law.

Indexation is necessary to ensure that taxpayers do not lose eligibility for the EITC. Under current law, an estimated 16.7 million taxpayers with children will claim the EITC in 1996. If benefit thresholds are not adjusted for inflation, participation would shrink to 14.8 million by 2000.

Eliminating indexation does not address the issue of fraud and abuse at all. Instead, it denies eligibility for the EITC to millions of law-abiding working taxpayers and reduces the benefits of millions of others who are playing by the rules. A number of tax provisions are indexed for inflation each year. These include the personal exemption, standard deduction amount, the width of the income tax brackets, the phase-out ranges for the personal exemption and deduction amounts, and the social security earnings ceiling. It is inappropriate to suspend indexation on the one provision which is solely targeted to low-income taxpayers.

The amendment would also limit eligibility for the EITC by adding new restrictions on the amounts and types of income held by recipients. The investment income cap would be lowered from $2,350 to $1,000. Net capital gains and passive partnership and estate income would also be added to the investment income cap. We would have serious reservations about lowering the investment income cap from $2,350 to $1,000.

The amendment's sponsors argue that at prevailing interest rates, a $1,000 investment cap is associated with about $16,700 of assets, and that it is inappropriate to provide the EITC to taxpayers with savings this high. While we agree that taxpayers with large amounts of assets should not receive the EITC, we view the $1,000 investment income cap as too restrictive. Low and moderate-income families should be encouraged to save for down-payments on homes, start-up capital for businesses of their own, their children's education or their own retraining. For example, the median price for a home purchased in 1994 by a first-time homeowner was $125,000, with an average downpayment of 13.7 percent of the price (or $17,125), while the costs of a four-year education at a typical state university exceeded $25,000. Under the proposal, the EITC would be denied to many families saving for these investments in their futures unless they liquidated their savings or shifted their investments to exempted assets.

The amendment would also restrict eligibility for the EITC by expanding the definition of income. For purposes of determining eligibility for the EITC, adjusted gross income would be expanded to include non-taxable social security benefits, child support payments, non-taxable pension income, and tax-exempt interest. We have serious reservations about the expansion of adjusted gross income to include these items.

We have serious concerns about the imposition of an additional tax on social security benefits of taxpayers who qualify for the EITC. The EITC would be reduced by up to over 19 cents for each additional dollar of social security benefits. Low-income elderly workers with

children could be subject to higher taxes on social security benefits than some of their better-off neighbors. In part, a portion of workers' social security benefits (as well as non-taxable pension income) represent the return of their own contributions from previously taxed income. The proposal could affect non-elderly workers with young children, too. The EITC would be reduced or eliminated for a low-wage worker whose disabled spouse receives disability insurance benefits. Reducing the EITC benefits of social security recipients could also compound the work disincentives already present in the social security programs.

The tax system does not count child support as income to the custodial parent because child support payments are a continuation of the other parent's obligation to support his or her child. Custodial parents should be encouraged to seek child support, rather than being penalized for obtaining it. As a result, we have serious reservations about this provision as well. This provision would also add complexity to the determination of EITC eligibility and would be difficult to verify. In particular, the IRS does not currently receive information about child support payments.

In combination, these proposals would reduce the EITC for 19 million taxpayers, on average, by $602 (2000 law measured at 1996 income levels). Taxpayers with two or more families would be most adversely affected by these provisions. For eight million taxpayers with two or more children, the EITC would be reduced, on average, by $886.

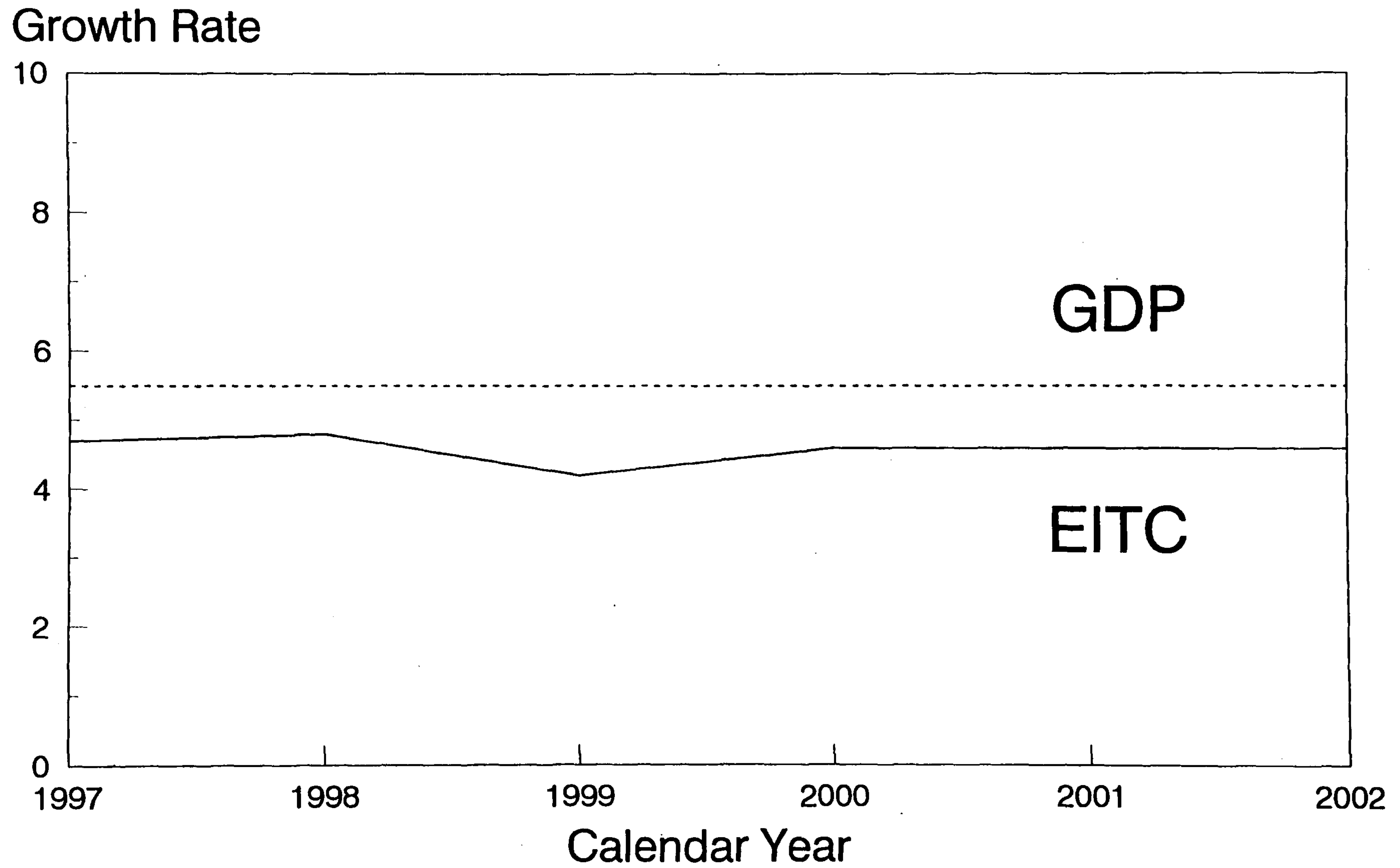
The Administration is committed to improving compliance with the EITC rules. Its actions in the last two years are clear evidence of this commitment. The compliance problems which the Administration is addressing should not be used as an excuse to eliminate or reduce the EITC benefits to all low-income working people. Consequently, the Administration strongly opposes proposals to eliminate indexation or to add complexity to the EITC eligibility criteria.

The Administration is committed to taking additional steps to improve the administration of the EITC. We would be interested in exploring with Congress legislative proposals to improve the ability of the IRS to verify eligibility for the EITC. These efforts might include requiring States to provide compatible and timely data on welfare and food stamp beneficiaries to the IRS, so that the IRS could better determine if an EITC qualifying child was claimed by the appropriate taxpayer. Reporting requirements for non-taxable earned income, which is used in the calculation of the EITC, could be enhanced as well.

* * * * *

This concludes my remarks. Thank you once again for providing me with the opportunity to testify. I would be pleased to answer any questions that the Committee may have.

Figure 1: Growth in the EITC and GDP*
1997 - 2002



*Under current law and Administration's January budget assumptions

Figure 2: The Earned Income Tax Credit, 1995

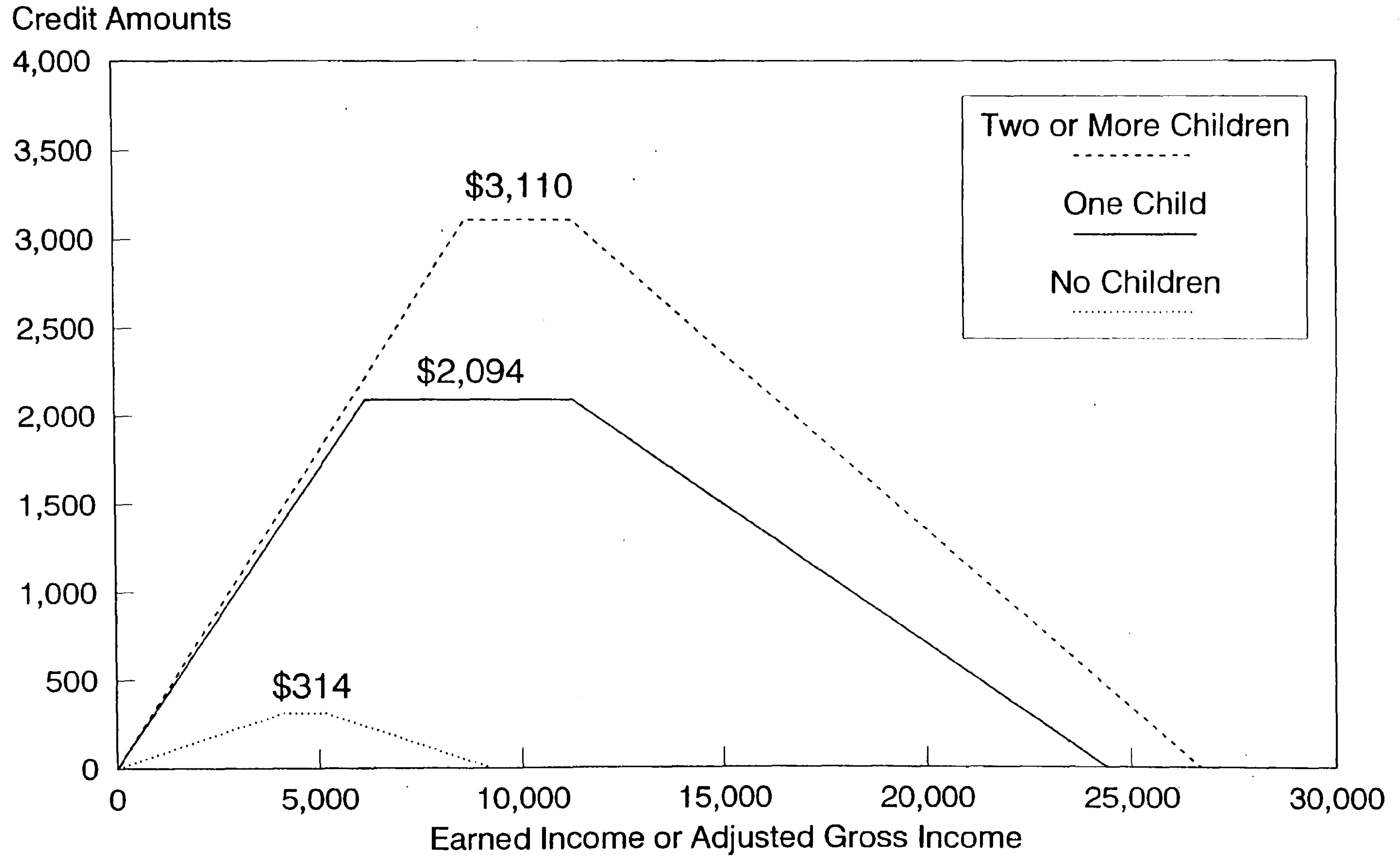


Figure 3: The Earned Income Tax Credit, 1996

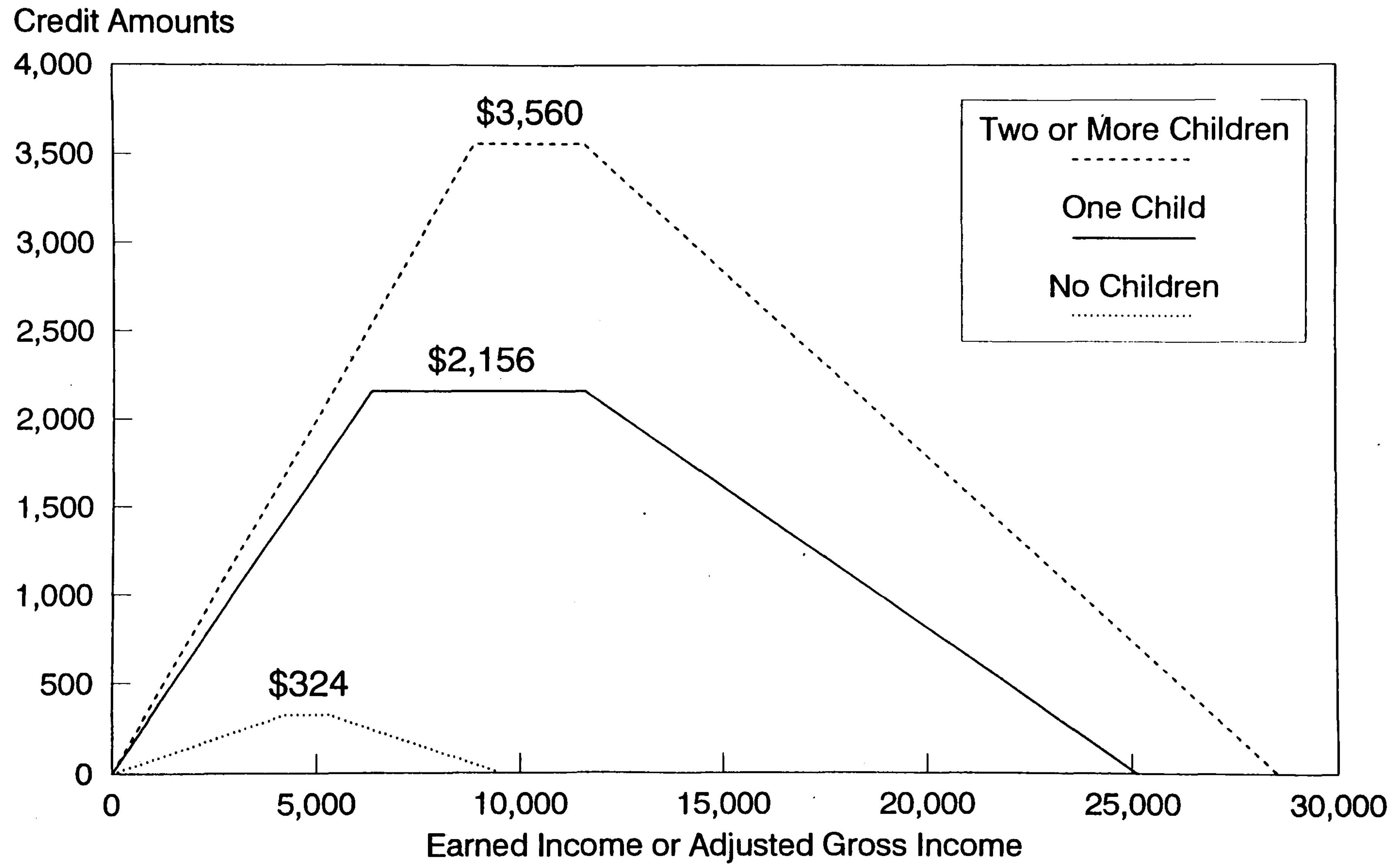


Figure 4: The Earned Income Tax Credit Under OBRA 1990 and OBRA 1993, Fully Phased In

Workers with Two or More Children, 1996 Dollars

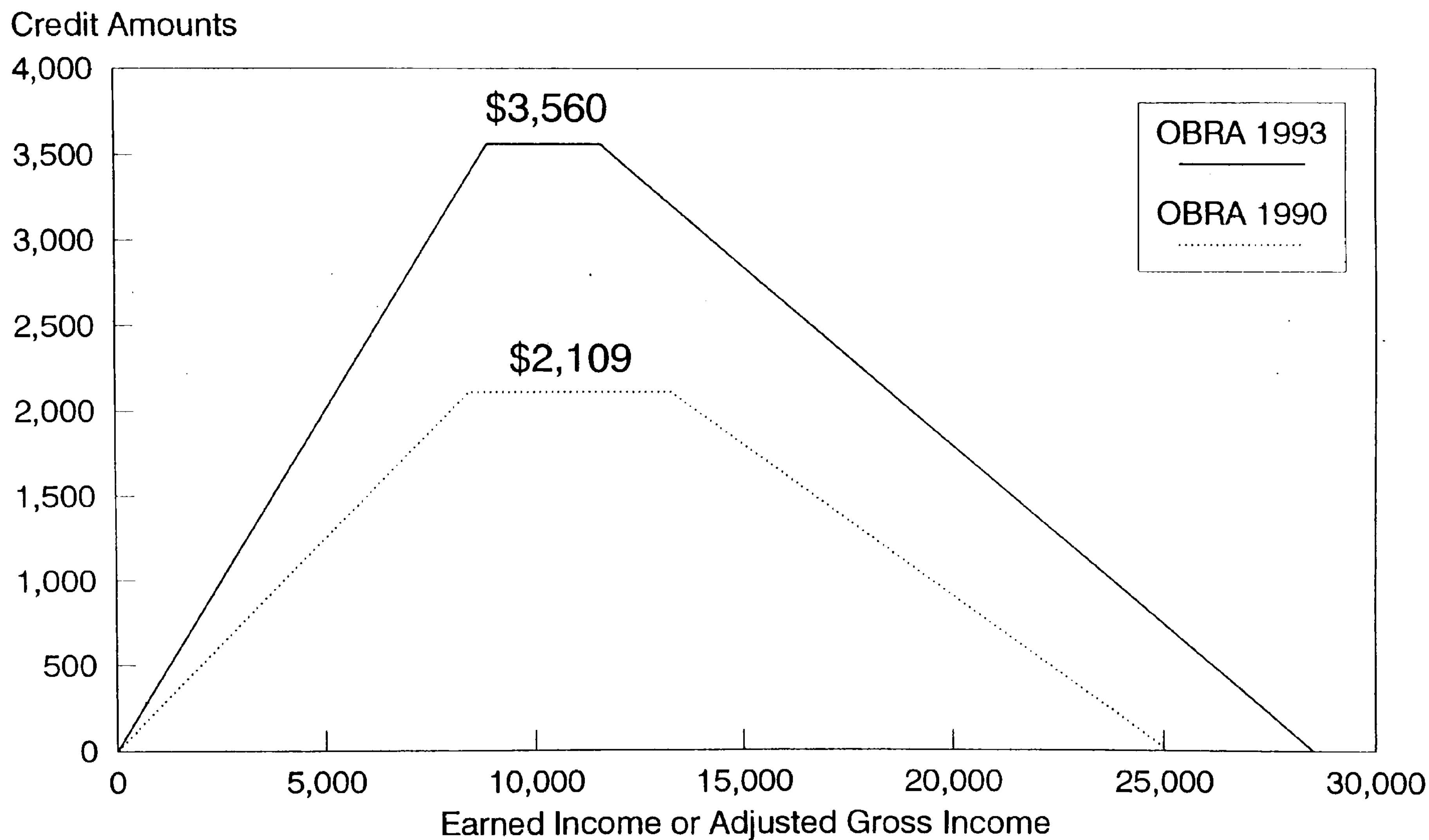
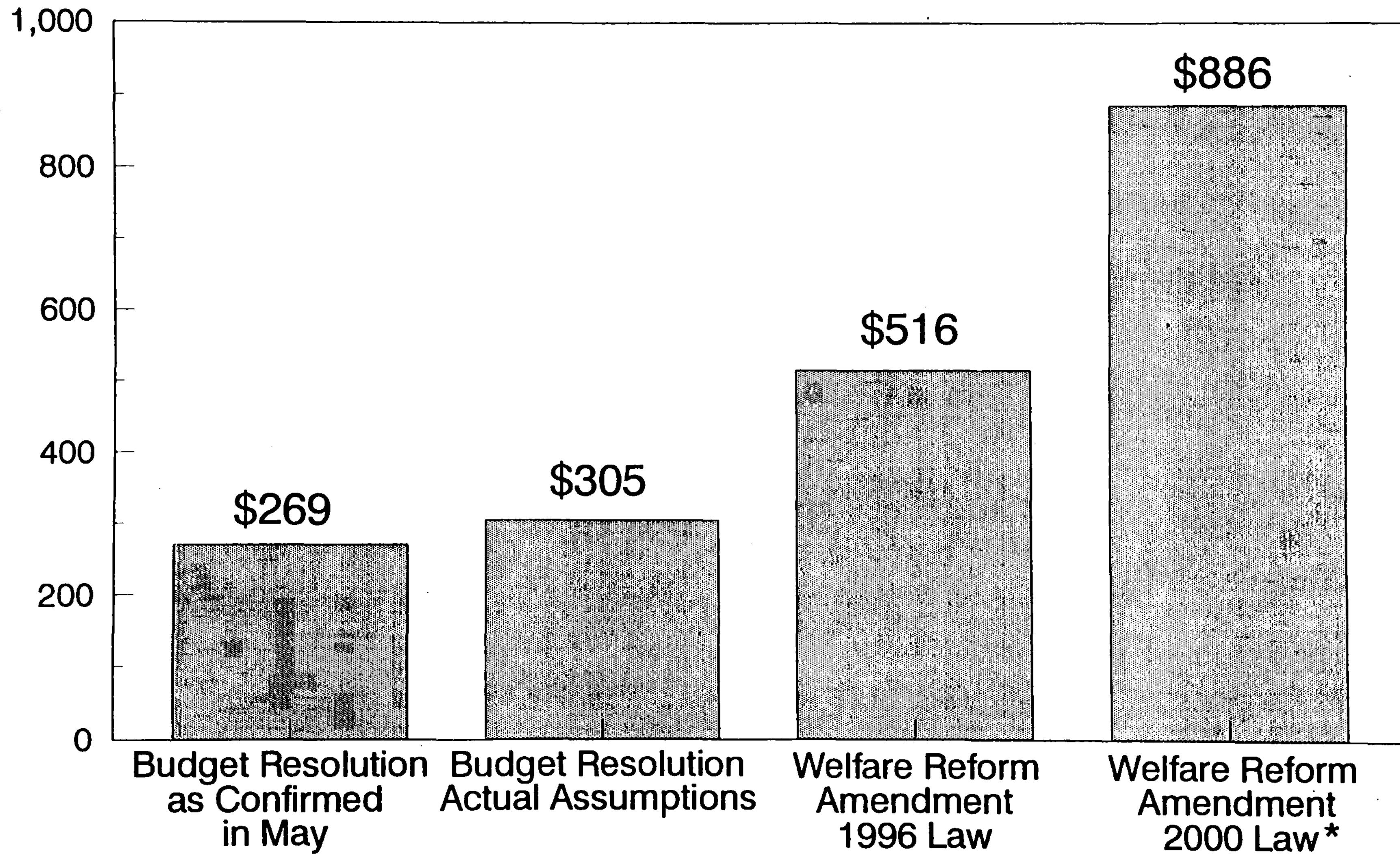


Figure 5: Average Tax Increase for Taxpayers with Two or More Children



* Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

Average EITC Tax Increases
1996 Income Levels

	Budget Resolution		Welfare Reform Amendment	
	Confirmed assumptions in May	Actual assumptions	1996 Law	2000 Law*
Total EITC Recipients				
Number of Affected Taxpayers	12 million	14 million	19 million	19 million
Average Tax Increase	$235	$239	$311	$602
Taxpayers with Two or More Qualifying Children				
Number of Affected Taxpayers	8 million	8 million	8 million	8 million
Average Tax Increase	$269	$305	$516	$886
Taxpayers with One Qualifying Child				
Number of Affected Taxpayers	0	2 million	7 million	7 million
Average Tax Increase	$0	$137	$166	$563
Taxpayers without Qualifying Child				
Number of Affected Taxpayers	4 Million	4 Million	4 Million	4 Million
Average Tax Increase	$173	$173	$173	$173

Department of the Treasury
Office of Tax Analysis

June 7, 1995

Estimate reflects effects of deindexation by the year 2000, estimated at 1996 income levels.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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For Release Upon Delivery
Expected at 11 a.m.
June 8, 1995

**STATEMENT OF JOHN D. HAWKE, JR.
NOMINEE FOR
UNDER SECRETARY FOR DOMESTIC FINANCE
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE**

Mr. Chairman, Senator Moynihan, and members of the Committee, I am deeply honored to appear before the Committee today. I especially want to thank you, Chairman Packwood, for bringing my nomination up for hearing in such a timely fashion.

The prospect of serving in President Clinton's Administration and participating in the important work of this distinguished Committee is enormously exciting and challenging. I am particularly grateful to Secretary Rubin and Deputy Secretary Newman for their strong support and for the confidence they have reposed in me. They have assembled a tremendously talented group of people at the Treasury Department, and it is my earnest hope that I will be able to make a contribution to their efforts.

While I have always considered myself a New Yorker -- having been born, brought up and educated there -- my professional life has been spent in Washington -- as a law clerk to a wonderful appellate judge, Judge E. Barrett Prettyman; as counsel to a House Education Subcommittee; as a practicing lawyer at Arnold & Porter, where I served as Chairman for eight years; as a teacher of law at Georgetown University; and as a banking regulator, in the position of General Counsel to the Federal Reserve Board under the chairmanship of Arthur Burns. Since my time at the Federal Reserve 20 years ago, it has been my hope that I would be able some day to return to government service, and I am profoundly grateful to the President for making this hope come true.

RR-359

I am especially pleased to have the opportunity to serve at the Department of the Treasury. Treasury is at the epicenter of some of the most critical issues our country confronts, and the Under Secretary for Domestic Finance will have important responsibilities with respect to many of these issues -- particularly those dealing with the health, efficiency and competitiveness of our system of financial institutions. We have before us not only the challenge of energizing the financial services system of the 21st Century, but also the imposing responsibility of assuring that American taxpayers will never again be called upon to shoulder the burden of losses suffered by that system.

While I have had the good fortune to be able to learn something of these issues during my career, I approach the challenge of the Under Secretary's position with great humility. Even a lifetime of experience cannot prepare one fully to deal with the subtleties and complexities of the issues on our agenda today.

I can pledge to the Committee, however, that I will devote my full energies to the task, and I look forward to working with this and other committees of the Congress as we jointly try to serve the public's interest in finding effective means of dealing with these issues.

It has been a privilege for me to appear before you today, and I would be pleased to respond to any questions the Committee may have.

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Robert E. Rubin
Secretary of the Treasury
testimony before the
Senate Committee on Banking, Housing, and Urban Affairs
Financial Services Negotiations
June 8, 1995

Introduction

Mr. Chairman, members of the committee, I am pleased to discuss with you the status of the financial services negotiations now underway under the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO). We are working very hard, through talks in Geneva as well as high-level meetings around the world, to win new opportunities for our firms to compete worldwide. Our goal is to gain commitments from the key developed and developing countries that they will open their markets to our financial services firms, and treat our firms as well as they treat their own. Specifically, we want these key countries to commit through the GATS to granting our firms substantially full access to their markets, and national treatment in those markets, within some defined time period.

Offers now on the table remain inadequate. In order for the United States to accept an MFN obligation, other countries must make commitments to maintain our firms' current access, extend national treatment to U.S. and other foreign firms, and remove serious impediments to access.

The Importance of Financial Services

Let me explain why we have placed so much emphasis on financial services. There are two chief reasons: to help the U.S. economy, and to advance the world's interests in the development of international capital markets.

RR-360

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First and foremost, financial services are an area of enormous importance to the United States economy. Our financial companies accounted for over 7 percent of GDP in 1993 -- more than $450 billion in revenues. U.S. firms are global leaders in scores of financial industries with enormous worldwide potential -- mutual fund management, asset securitization, investment banking -- to cite but a few. We have a very strong competitive advantage in this burgeoning area.

Our cross-border exports of financial services already amounted to some $8.5 billion in 1994, excluding U.S. affiliates of foreign firms. These exports have enjoyed average annual growth of more than 10 percent over the past three years. A market-opening agreement would set the stage for continued strong growth by American firms. We simply cannot allow this important United States sector to be excluded from progress in the international trading system.

American financial services firms can move rapidly to take advantage of new opportunities when government-made barriers are removed. By way of example, U.S. firms began calling Treasury officials within hours after Japan agreed to create a new asset-backed securities market last February, asking for information about how they could move ahead with specific transactions. That is how quickly U.S. firms can seize new opportunities, when inhibiting foreign regulations are cleared away.

There is another reason why we have devoted so much effort to financial services. The development of global financial markets has a significance which goes far beyond their importance to specific firms, or even to the United States alone. More than ever before, well-functioning capital markets are essential to the health of the world economy. Capital needs in emerging markets are outstripping the capacity of traditional financial systems. State of the art banking and broad, deep securities markets are needed to mobilize funds for electrical power, telecommunications, and other infrastructure.

Allowing in foreign firms with high levels of expertise is one of the surest ways to help deepen a nation's capital markets. That opens up broad new avenues for economic progress worldwide. American firms can lead the way.

Post-Uruguay Round Negotiations

The talks in which we are now engaged are an extension of the Uruguay Round GATS negotiations completed in December, 1993. As you know, we entered the Uruguay Round seeking to level the financial services playing field. We wanted to win commitments from other countries that they would grant our firms substantially full market access and national treatment -- the same kind of access and treatment which it has been our practice to grant to foreign firms. That was the condition upon which we insisted, if we were to bind our own market-opening practices under the GATS, by committing ourselves to granting most favored nation (MFN) status to all WTO member countries.

A few parties to the negotiations made offers that would have provided what we were

seeking. However, many offers did not provide acceptable market access and national treatment commitments. Countries sought to maintain a range of restrictions -- from prohibitions on new licenses for foreign firms to discriminatory regulatory and legal requirements -- that could not be justified, except as a way of keeping foreign firms out. Some also held back from committing themselves to allowing U.S. firms now in their markets to continue operations on current terms. In the end, we could not commit ourselves to granting essentially full market access and national treatment to firms from other countries that would not open their markets to our firms and commit to keeping them open.[1]

Rather than locking ourselves into a flawed pact, we reached an interim agreement. The United States and some others took a broad exemption to the GATS most favored nation obligation. However, we agreed to suspend the exemption for the first six months of the World Trade Organization's existence, while we negotiated further.

The deadline for these extended negotiations is June 30.

Progress Since December 1993

Treasury and USTR officials have held several rounds of negotiations with WTO members over the past 16 months. In addition, top-level officials from Treasury have met with many of their foreign counterparts to stress our concerns about the need for stronger commitments, if a GATS agreement is to be reached. It has been a frequent theme in my meetings with other countries' finance ministers.

To further the negotiations, the United States has taken a new approach since December 1993. Realizing that financial market liberalization takes time in developing countries, we have told our negotiating partners that they may offer to implement market opening commitments over a transitional phase. We will agree to such a phase-in so long as it is limited, provides substantially full national treatment, and ends with substantially full market access for our own and other foreign firms.

We have made some headway. The bilateral financial services agreements with Japan on banking and securities negotiated by Treasury and on insurance negotiated by USTR earlier this year removed one significant hurdle in the way of progress in GATS. The Administration has already briefed the Congress on the scope of these important agreements. To summarize, the Japanese assented to the most comprehensive set of market-opening measures in a decade, including access to the $1.5 trillion fund management market, liberalization of an array of securities instruments, and extensive deregulation of capital controls which disadvantaged foreign firms.

For a description of specific offers made by other GATS members at the close of the Uruguay Round, see Report on Status of Financial Services Negotiations Under the General Agreement on Trade in Services, April 30, 1995, p.5-7.

Japan has pledged to bind the benefits we received in our agreements in its GATS schedule, as appropriate. It is important for Japan to do so and thereby subject its commitments to WTO discipline.

With Japan having moved, the stage is set for other nations to come forward with good offers in the GATS.

Negotiations with other WTO members have intensified since we reached our agreements with Japan. Bilateral and multilateral talks were held in Geneva over the week of March 27. On my mid-April trip to India and other Asian states I met with several finance ministry colleagues; I stressed how important it is for them to improve their offers. Countries submitted new offers in mid-May, and another round of talks was held over the week of May 15. Our negotiators are in Geneva at this very moment, hammering away to attain our objectives.

We have made some progress with other WTO members. Argentina, the then 12 member European Union, New Zealand and Switzerland all offered substantially full market access and national treatment in banking and securities in their December 1993 offers. Since then, Norway and South Africa have come forward with similar, high-quality commitments. Moreover, Austria, Finland and Sweden have joined the EU and would be covered by the Union's very good schedule.

A number of other countries' offers have improved somewhat since December 1993, although problems remain with them. One Latin American country has pledged to eliminate minimum capital requirements that discriminate between foreign and domestic institutions. An important Asian country has proposed committing itself to binding already-implemented regulatory changes within the GATS framework. Other countries have offered small increases in market access or improvements in the range of services that foreign firms can provide.

Unfortunately, the improvements offered by these and other countries to date remain inadequate. Let me cite just a few of the barriers we are up against. Some very important markets want to continue limiting the number of licenses granted to foreign firms. Others want to reserve the right to restrict entry by foreign firms entirely, or limit the ways foreign firms can enter -- whether through branches or subsidiaries. Some countries want to retain the right to discriminate against foreigners with regulations that have no prudential justification, such as discriminatory capital-asset ratio requirements. Still others want to apply rules that, for all practical purposes, would keep out foreign asset managers and investment advisors.

Some offers stop short of even protecting the current rights of firms already established in a market.

The Final Opportunity

Mr. Chairman, our officials are currently in Geneva, where the final stage of negotiations is underway. As I have said, present offers remain inadequate. I strongly hope that other countries' offers will improve to the point where we can wholeheartedly enter into an agreement, and accept an MFN obligation.

To be sure, the decision to accept or refuse an MFN obligation is a tough one. The benefits of accepting an MFN obligation could be substantial. Countries which have made attractive market-opening commitments would bind those commitments through the GATS. U.S. firms would be assured of important new opportunities to compete in exciting new markets. As important, for the first time key markets such as those of the European Union and Japan would bind their open-market practices within the GATS. The World Trade Organization would give us a ready means for enforcing those commitments. Our financial firms would face a more certain and predictable international environment, knowing that the clock could never be set back.

But there would be a serious downside to our irrevocably accepting an MFN obligation, assuming that commercially significant countries continued to retain restrictions against foreign firms. GATS most-favored nation rules would not allow us to treat countries which do not open their markets to us any differently from those that do. All WTO member countries' firms would be entitled to full market access and national treatment in the United States. In other words, the few closed markets would be able to free-ride on the agreement we reach with other market-opening WTO members, such as the European Union. We would lose the leverage we now have to open markets by taking other countries' practices into account when their firms apply to do business over here.

It could be similarly detrimental to accept an irrevocable MFN obligation while there are key markets which refuse to commit themselves to protecting the rights of U.S. firms already established. If these countries decide to backtrack and slap restrictions on established foreign firms, we could find ourselves without any means to respond.

We will await the last set of offers made by WTO member countries. Then, we will carefully consider the extent to which countries have pledged to open their markets to our firms. If they have dealt with the serious restrictions on market access and national treatment that are out there, we will accept an MFN obligation. If they have not, we will retain our exemption from MFN. We will consult both with the Congress and with U.S. industry in making our decision, as we have all along the way.

Conclusion

Mr. Chairman, let me conclude by assuring you that Treasury will do all it can over the next few weeks to try to win a satisfactory agreement for our financial services firms. Financial services is one of the key sectors of tomorrow. Our firms are superb competitors, and should have the right to compete worldwide. That is our goal. We will settle for nothing less. Thank you.

5/26/95
Signature
package

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[INTL-0024-94]

RIN 1545-AS83

Taxpayer Identifying Numbers (TIN)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking; Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document withdraws the notice of proposed rulemaking relating to taxpayer identifying numbers published in the **Federal Register** on September 27, 1990, at 55 FR 39486. This document also contains proposed amendments to the regulations relating to requirements for furnishing a taxpayer identifying number on returns, statements, or other documents. These amendments set forth procedures for requesting a taxpayer identifying number for certain alien individuals for whom a social security number is not available. These numbers would be called "IRS individual taxpayer identification numbers." These amendments also require certain foreign persons to furnish a taxpayer identifying number on their tax returns. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of the oral comments to be presented at the public hearing scheduled for 10 a.m. on August 11, 1995, must be received by July 21, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (INTL-0024-94), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (INTL-0024-94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in the Internal Revenue Service Auditorium, 7400 corridor, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Lilo A. Hester (202) 874-1490; concerning submissions and the hearing, Christina Vasquez (202) 622-7180 (not a toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224.

The collection of information from certain resident alien individuals and foreign persons required to furnish taxpayer identifying numbers under section 6109 of the Internal Revenue Code (Code) is found in §301.6109-1. This information will be used by the IRS for tax administration purposes. The likely respondents and recordkeepers are certain resident alien individuals and foreign persons such as nonresident alien individuals and foreign corporations who make a return of tax.

The burden for the collection of information contained in §301.6109-1(d) is reflected in the burden of Form W-7.

Background

This document withdraws the notice of proposed rulemaking under section 6109 published in the **Federal Register** on September 27, 1990 at 55 FR 39486. This document also contains proposed amendments to 26 CFR part 301 to provide rules under section 6109 of the Internal Revenue Code relating to a new type of taxpayer identifying number.

Explanation of Provisions

In General

Section 6109(a) of the Code provides that, when required by regulations, a person must furnish a taxpayer identifying number (TIN) for securing proper identification of that person on any return, statement, or other document made under the Code. The assignment of a unique and permanent number to each taxpayer is important for the effective operation of the IRS automatic data processing system. The numbering system improves the IRS' ability to identify and access database records; to match

information provided on tax and information returns, statements, and other documents with the proper taxpayers; and to provide better customer service to taxpayers.

The Treasury Department and the IRS are concerned about individuals who are filing tax returns but who are unable to obtain a social security number. In order to insure that all taxpayers required to provide a TIN for tax purposes are able to obtain one, the IRS is developing a separate numbering system that will make unique and permanent numbers available to those individuals. The proposed regulations explain how alien individuals, whether resident or nonresident, can obtain an IRS individual taxpayer identification number from the IRS.

The regulations require any foreign person who makes a return to provide a TIN on the return. This TIN may be an employer identification number, a social security number, or a new IRS individual taxpayer identification number in the case of an alien individual who does not have a social security number and cannot obtain one.

The Treasury Department and the IRS are also considering changes to the procedures that apply to withholding tax on payments to foreign persons in order to encourage compliance and reduce paperwork burden. The Treasury Department and the IRS are aware that significant changes in this area will impact some aspects of transactions subject to withholding. Accordingly, the Treasury Department and the IRS intend to move very cautiously, particularly by considering the possible effect of changes in these procedures on investment decisions by foreign persons and

by considering the adequacy of existing procedures for those taxpayers who wish to continue to comply with current rules. Generally, no new procedures will be adopted without adequate opportunity for public comment and appropriate transition periods before taking effect. This will not, however, preclude the Treasury Department and the IRS from adopting new procedures to replace the current address rule for dividends.

Specific Changes

The most significant changes proposed by these regulations are described below. The first change is the introduction of a new IRS-issued TIN for use by alien individuals who currently do not have, and are not eligible to obtain, social security numbers. The number is called an IRS individual taxpayer identification number (ITIN). This number is intended to be issued to alien individuals, whether resident or nonresident, who are currently required to furnish a number for tax purposes but who are not entitled to obtain social security numbers. Therefore, these amendments are designed to help taxpayers maintain compliance with TIN requirements under the Code and regulations. The Social Security Administration limits its assignment of social security numbers to individuals who are U.S. citizens and alien individuals legally admitted to the United States for permanent residence or under other immigration categories which authorize U.S. employment. Therefore, IRS-

issued numbers are necessary for those individuals who need a TIN but cannot qualify for a social security number.

The second change is to modify the existing rule set forth in §301.6109-1(g) that currently excludes from the general requirement of providing a TIN, foreign persons that do not have either (1) income effectively connected with the conduct of a U.S. trade or business or (2) a U.S. office or place of business or a U.S. fiscal or paying agent. Under the proposed regulations, the exclusion is modified to require that any foreign person who makes a return of tax furnish its TIN on that return. This change is intended solely to address the IRS' and Treasury's concern that, without TINs, taxpayers cannot be identified and tax returns cannot be processed effectively.

The Treasury Department and the IRS are giving added thought to applying the TIN requirement to facilitate changes to the procedures that apply to withholding taxes on payments to foreign persons. Decisions with respect to the withholding tax system have yet to be made, and when made, will be proposed in subsequent regulations. The Treasury Department and the IRS will proceed cautiously in expanding the scope of the TIN requirement and will consider the adequacy of existing procedures for those taxpayers who wish to continue to comply with current rules.

The IRS individual taxpayer identification numbers issued under this regulation will differ from, and replace, the "temporary" TINs the IRS currently issues under the authority of section 6109(c). For example, after declaring in Rev. Rul. 84-158, 1984-2 C.B. 262, that a partnership must request the social securi

numbers of its individual partners (including a nonresident alien limited partner), the IRS announced in Rev. Rul. 85-61, 1985-1 C.B. 355, that it would issue temporary numbers to nonresident alien limited partners who do not have, and cannot obtain, social security numbers. All of these temporary numbers, however, will be retired upon subsequent revocation of these revenue rulings.

IRS individual taxpayer identification numbers are intended for tax use only. For example, the numbers will create no inference regarding the immigration status of a foreign person or the right of that person to be legally employed in the United States. The IRS individual taxpayer identification numbers and the information obtained by the IRS as a result of issuing numbers constitute confidential taxpayer information. Section 6103 strictly prohibits the disclosure of this information to other government agencies, private entities, or citizens. Disclosure in violation of the restrictions under section 6103 may lead to civil or criminal penalties.

Section-By-Section Analysis

Proposed §301.6109-1(a)(1)(i) provides a general description of the types of TINs, including the new IRS individual taxpayer identification number. The IRS individual taxpayer identification number will begin with a specific number designated by the IRS and will otherwise resemble a social security number. Proposed §301.6109-1(a)(1)(ii) provides general rules for use of the different TINs, including the rule for an estate to obtain and furnish its employer identification number when required, such as in its capacity as a payor or payee of

royalties. This rule for estates was announced previously in the proposed regulations under section 6109 published in the **Federal Register** at 55 FR 39486 on September 27, 1990.

The requirement for foreign persons to provide a TIN if they have income effectively connected with the conduct of a U.S. trade or business, if they have a U.S. office or place of business, or a U.S. fiscal or paying agent during the taxable year, or if they are treated as resident alien individuals under section 6013(g) or (h), is restated without change in proposed §§301.6109-1(b)(2) and (c). However, proposed §301.6109-1(b)(2)(iv) modifies the exclusion currently provided in §301.6109-1(g) with respect to other foreign persons by providing that a foreign person filing a return of tax is subject to the TIN requirements under section 6109. For this purpose, a return of tax includes income, estate, and gift tax returns but excludes information returns, statements or other documents. This requirement is proposed to be effective for foreign persons who file returns of tax after December 31, 1995.

The provisions of §301.6109-1(d)(2) dealing with obtaining an employer identification number are unchanged except to specify that a Form SS-4 will be available from U.S. consular offices abroad. This change is intended to accommodate those foreign persons that are required to provide an employer identification number.

The procedures governing the new IRS individual taxpayer identification number, including procedures for obtaining such a number, are set forth in proposed §301.6109-1(d)(3). An IRS

individual taxpayer identification number is applied for on Form W-7, Application for IRS Individual Taxpayer Identification Number. Under normal procedures, the application is submitted to the IRS for processing together with required documentation designed to substantiate foreign status, as well as true identity. Further guidance will be issued to specify the types of acceptable documentation. Because the IRS intends to rely as much as possible on the identifying documents that are customarily used in a foreign jurisdiction to identify a resident in that jurisdiction, the documentation requirements are likely to vary from country to country. Comments and suggestions are solicited regarding the type of documents that could be used reliably to establish the identity of taxpayers and their foreign status.

The IRS is planning a wide distribution of application forms in the United States and abroad and will insure that the form is easily available to the public. Further, in order to facilitate the application process and to expedite the issuance of the TINs, the regulations propose to authorize agreements that would permit certain persons to act as an applicant's agent. These agents are called acceptance agents. Generally, an acceptance agent may include financial institutions or educational institutions, i.e., institutions that are likely to come in contact with a large number of foreign taxpayers earning U.S. source income and that can establish to the IRS that they have the resources and procedures necessary to undertake the duties expected from an acceptance agent.

Under an agreement with the IRS, an acceptance agent would assume responsibility for providing the necessary information to the IRS for the issuance of a number, together with a certification that the applicant is a foreign person. The certification would be issued on the basis of prescribed documentation obtained from the applicant. Under this procedure, no documentation generally would be required to be furnished to the IRS, except as part of a verification process by which the IRS may periodically verify the agent's compliance with the agreement. In order to streamline the process and facilitate the agent's due diligence under the agreement, the agreement would specify the type of documentation that must be obtained to verify foreign status and true identity of an applicant.

Proposed §301.6109-1(d)(4) provides rules for the coordination of the different TINs. A person entitled to a social security number will not be issued an IRS individual taxpayer identification number. Once a person has a social security number, that number must be used for all tax purposes, even though the person is a nonresident alien. A nonresident alien who is issued an IRS individual taxpayer identification number and later becomes entitled to a social security number (e.g., becomes a U.S. resident under an immigration visa) must apply for a social security number and must stop using the IRS number. IRS matching systems will help the IRS detect taxpayers who are incorrectly using an IRS individual taxpayer identification number. The IRS will contact those individuals and request that they obtain a social security number.

Section 301.6109-1(f) is modified to cross reference the new penalty provisions under sections 6721 through 6724.

Proposed §301.6109-1(g)(1) provides the general rule that, in the IRS records, a person with a social security number or an employer identification number will normally be identified as a U.S. person. Regulations to be issued at a later time may make it important for a person to be identified correctly in the IRS records as a U.S. or a foreign person. Accordingly, these proposed regulations provide that the foreign person with a social security number or an employer identification number may establish foreign status with the IRS. Any foreign person that holds an employer identification number issued prior to the effective date of this proposed regulation may continue to use its employer identification number for tax purposes. However, when requested by the IRS, such persons must apply for a new employer identification number that is exclusively dedicated to foreign persons. Proposed §301.6109-1(g)(1) also provides that an IRS individual taxpayer identification number is considered by the IRS to belong to a nonresident alien individual if the foreign status of the individual is established upon initial application for the number. If foreign status is not established, the IRS will generally require the individual to apply for a social security number. In rare cases when a resident alien individual is not eligible for a social security number, the taxpayer will be entitled to use an IRS individual taxpayer identification number, and the IRS will note in its records that the number belongs to a U.S. person.

No re-filings are required in order to maintain foreign status described in proposed §301.6109-1(g)(1). However, proposed §301.6109-1(g)(2) provides that if circumstances change (for example, a taxpayer becomes a U.S. resident), then the taxpayer must notify the IRS to record the change of status. The IRS will issue guidance on procedures for notifying the IRS of a person's status or changes thereof.

Proposed §301.6109-1(g)(3) concerns disclosure provisions. In order to make the acceptance agent's procedures possible, it is necessary that taxpayers requesting a TIN through an acceptance agent authorize the disclosure of taxpayer information to the extent necessary to allow communications between the IRS and the acceptance agent in the course of the issuance and administration of the number. Accordingly, the application form will include a waiver of the prohibition against disclosure of taxpayer information in order to permit the IRS to communicate with an acceptance agent regarding matters related to the assignment of a TIN.

Proposed Effective Date

These regulations would apply to returns, statements, or documents filed after December 31, 1995, except the provision relating to the requirement for an estate to obtain an employer identification number applies on and after January 1, 1984. Thus, these regulations would apply to foreign persons described in proposed §301.6109-1(b)(2)(iv) who file a return of tax after December 31, 1995.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight (8) copies) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for 10 a.m. on August 11, 1995. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic by July 21, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Lilo A. Hester of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, IRS. However, other personnel from the IRS and Treasury Department participated in their development.

Withdrawal of Proposed Regulations

The previously proposed regulations under §301.6109-1, as published in the **Federal Register** on September 27, 1990, at 55 FR 39486, are hereby withdrawn.

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301--PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 301.6109-1 also issued under 26 U.S.C. 6109(a), (c), and (d). * * *

Par. 2. Section §301.6109-1 is amended as follows:

1. Paragraphs (a)(1), (b), (c), and (d)(2) are revised.

2. Paragraphs (d)(3) and (4) are added.

3. Paragraphs (f), (g), and (h) are revised.

The revisions and additions read as follows:

<u>§301.6109-1 Identifying numbers</u>.

(a) <u>In general</u>--(1) <u>Taxpayer identifying numbers</u>--(i) <u>Types</u>. There are generally three types of taxpayer identifying numbers: social security numbers, Internal Revenue Service (IRS) individual taxpayer identification numbers, and employer identification numbers. Social security numbers take the form 000-00-0000, IRS individual taxpayer identification numbers take the form 000-00-0000 but begin with a specific number designated by the IRS, and employer identification numbers take the form 00-0000000. Both social security numbers and IRS individual taxpayer identification numbers identify individual persons. For the definition of social security number and employer identification number, see §§301.7701-11 and 301.7701-12, respectively. For the definition of IRS individual taxpayer identification number, see paragraph (d)(3) of this section.

(ii) <u>Uses</u>. Except as otherwise provided in applicable regulations under this title or on a return, statement, or other document, and related instructions, taxpayer identifying numbers must be used as follows:

(A) Except as otherwise provided in paragraphs (a)(1)(ii)(B) and (D) of this section, an individual required to furnish a taxpayer identifying number must use a social security number.

(B) Except as otherwise provided in paragraph (a)(1)(ii)(D) of this section, an individual required to furnish a taxpayer identifying number but who is not eligible to obtain a social security number, must use an IRS individual taxpayer identification number.

(C) Any person other than an individual (such as corporations, partnerships, nonprofit associations, trusts, estates, and similar nonindividual persons) that is required to furnish a taxpayer identifying number must use an employer identification number.

(D) An individual, whether U.S. or foreign, who is an employer or who is engaged in trade or business as a sole proprietor should use an employer identification number as required by returns, statements, or other documents and their related instructions.

* * * * *

(b) <u>Requirement to furnish one's own number</u>--(1) <u>U.S. persons</u>. Every U.S. person who makes under this title a return, statement, or other document must furnish its own taxpayer identifying number as required by the forms and the accompanying instructions. A U.S. person whose number must be included on a document filed by another person must give the taxpayer identifying number so required to the other person on request.

For penalties for failure to supply taxpayer identifying numbers, see sections 6721 through 6724. For provisions dealing specifically with the duty of employees with respect to their social security numbers, see §31.6011(b)-2 (a) and (b) of this chapter (Employment Tax Regulations). For provisions dealing specifically with the duty of employers with respect to employer identification numbers, see §31.6011(b)-1 of this chapter (Employment Tax Regulations).

(2) Foreign persons. The provisions of paragraph (b)(1) of this section regarding the furnishing of one's own number shall apply to the following foreign persons--

(i) A foreign person that has income effectively connected with the conduct of a U.S. trade or business at any time during the taxable year;

(ii) A foreign person that has a U.S. office or place of business or a U.S. fiscal or paying agent at any time during the taxable year;

(iii) A nonresident alien treated as a resident under section 6013(g) or (h); and

(iv) Any other foreign person who makes a return of tax under this title (including income, estate, and gift tax returns) but excluding information returns, statements, or documents.

(c) Requirement to furnish another's number. Every person required under this title to make a return, statement, or other document must furnish such taxpayer identifying numbers of other U.S. persons and foreign persons that are described in paragraph (b)(2)(i), (ii), or (iii) of this section as required by the

forms and the accompanying instructions. If the person making the return, statement, or other document does not know the taxpayer identifying number of the other person, such person must request the other person's number. A request should state that the identifying number is required to be furnished under authority of law. When the person making the return, statement, or other document does not know the number of the other person, and has complied with the request provision of this paragraph, such person must sign an affidavit on the transmittal document forwarding such returns, statements, or other documents to the Internal Revenue Service, so stating. A person required to file a taxpayer identifying number shall correct any errors in such filing when such person's attention has been drawn to them.

(d) * * *

(2) Employer identification number. Any person required to furnish an employer identification number must apply for one, if not done so previously, on Form SS-4. A Form SS-4 may be obtained from any office of the Internal Revenue Service, U.S. consular office abroad, or from an acceptance agent described in paragraph (d)(3)(iv) of this section. The person must make such application in advance of the first required use of the employer identification number to permit issuance of the number in time for compliance with such requirement. The form, together with any supplementary statement, must be prepared and filed in accordance with the form, accompanying instructions, and relevant regulations, and must set forth fully and clearly the requested data.

(3) IRS individual taxpayer identification number--

(i) Definition. The term IRS individual taxpayer identification number means a taxpayer identifying number issued to an alien individual by the Internal Revenue Service, upon application, for use in connection with filing requirements under this title. The term IRS individual taxpayer identification number does not refer to a social security number or an account number for use in employment for wages. For purposes of this section, the term alien individual means an individual who is not a citizen or national of the United States.

(ii) General rule for obtaining number. Any individual who is not eligible to obtain a social security number and is required to furnish a taxpayer identifying number must apply for an IRS individual taxpayer identification number on Form W-7, Application for IRS Individual Taxpayer Identification Number, or such other form as may be prescribed by the Internal Revenue Service. Form W-7 may be obtained from any office of the Internal Revenue Service, U.S. consular office abroad, or any acceptance agent described in paragraph (d)(3)(iv) of this section. The individual shall furnish the information required by the form and accompanying instructions, including the individual's name, address, foreign tax identification number (if any), and specific reason for obtaining an IRS individual taxpayer identification number. The individual must make such application in advance of the first required use of the IRS individual taxpayer identification number to permit issuance of the number in time for compliance with such requirement. The

application form, together with any supplementary statement and documentation, must be prepared and filed in accordance with the form, accompanying instructions, and relevant regulations, and must set forth fully and clearly the requested data.

(iii) General rule for assigning number. Under procedures issued by the Internal Revenue Service, an IRS individual taxpayer identification number will be assigned to an individual upon the basis of information reported on Form W-7 (or such other form as may be prescribed by the Internal Revenue Service) and any such accompanying documentation that may be required by the Internal Revenue Service. An applicant for an IRS individual taxpayer identification number must submit such documentary evidence as the Internal Revenue Service may prescribe in order to establish alien status and identity. Examples of acceptable documentary evidence for this purpose may include items such as an original (or a certified copy of the original) passport, driver's license, birth certificate, identity card, or U.S. visa.

(iv) Acceptance agents--(A) Agreements with acceptance agents. A person described in paragraph (d)(3)(iv)(B) of this section will be accepted by the Internal Revenue Service to act as an acceptance agent for purposes of the regulations under this section upon entering into an agreement with the Internal Revenue Service, under which the acceptance agent will be authorized to act on behalf of taxpayers seeking to obtain a taxpayer identifying number from the Internal Revenue Service. The agreement must contain such terms and conditions as are necessary

to insure proper administration of the process by which the Internal Revenue Service issues taxpayer identifying numbers to foreign persons, including proof of their identity and foreign status. In particular, the agreement may contain--

(1) Procedures for providing Form SS-4 and Form W-7, or such other necessary form to applicants for obtaining a taxpayer identifying number;

(2) Procedures for providing assistance to applicants in completing the application form or completing it for them;

(3) Procedures for collecting, reviewing, and maintaining, in the normal course of business, a record of the required documentation for assignment of a taxpayer identifying number;

(4) Procedures for submitting the application form and required documentation to the Internal Revenue Service, or if permitted under the agreement, submitting the application form together with a certification that the acceptance agent has reviewed the required documentation and that it has no actual knowledge or reason to know that the documentation is not complete or accurate;

(5) Procedures for assisting taxpayers with notification procedures described in paragraph (g)(2) of this section in the event of change of foreign status;

(6) Procedures for making all documentation or other records furnished by persons applying for a taxpayer identifying number promptly available for review by the Internal Revenue Service, upon request; and

(7) Provisions that the agreement may be terminated in the event of a material failure to comply with the agreement, including failure to exercise due diligence under the agreement.

(B) Persons who may be acceptance agents. An acceptance agent may include any financial institution as defined in section 265(b)(5) or §1.165-12(c)(1)(v) of this chapter, any college or university that is an educational organization as defined in §1.501(c)(3)-1(d)(3)(i) of this chapter, any federal agency as defined in section 6402(f) or any other person or categories of persons that may be authorized by regulations or Internal Revenue Service procedures. A person described in this paragraph (d)(3)(iv)(B) that seeks to qualify as an acceptance agent must have an employer identification number for use in any communication with the Internal Revenue Service. In addition, it must establish to the satisfaction of the Internal Revenue Service that it has adequate resources and procedures in place to comply with the terms of the agreement described in paragraph (d)(3)(iv)(A) of this section.

(4) Coordination of taxpayer identifying numbers--(i) Social security number. Any individual who is duly assigned a social security number or who is entitled to a social security number will not be issued an IRS individual taxpayer identification number. The individual can use the social security number for all tax purposes under this title, even though the individual is, or later becomes, a nonresident alien individual. Further, any individual who has an application

pending with the Social Security Administration will be issued an IRS individual taxpayer identification number only after the Social Security Administration has notified the individual that a social security number cannot be issued. Any alien individual duly issued an IRS individual taxpayer identification number who later becomes a U.S. citizen, or an alien lawfully permitted to enter the United States either for permanent residence or under authority of law permitting U.S. employment, will be required to obtain a social security number. Any individual who has an IRS individual taxpayer identification number and a social security number, due to the circumstances described in the preceding sentence, must notify the Internal Revenue Service of the acquisition of the social security number and must use the newly-issued social security number as the taxpayer identifying number on all future returns, statements, or other documents filed under this title.

(ii) Employer identification number. Any individual with both a social security number (or an IRS individual taxpayer identification number) and an employer identification number may use the social security number (or the IRS individual taxpayer identification number) for individual taxes, and the employer identification number for business taxes as required by returns, statements, and other documents and their related instructions. Any alien individual duly assigned an IRS individual taxpayer identification number who also is required to obtain an employer identification number must furnish the previously-assigned IRS

individual taxpayer identification number to the Internal Revenue Service on Form SS-4 at the time of application for the employer identification number. Similarly, where an alien individual has an employer tax identification number and is required to obtain an IRS individual taxpayer identification number, the individual must furnish the previously-assigned employer identification number to the Internal Revenue Service on Form W-7, or such other form as may be prescribed by the Internal Revenue Service, at the time of application for the IRS individual taxpayer identification number.

* * * * *

(f) Penalty. For penalties for failure to supply taxpayer identifying numbers, see sections 6721 through 6724.

(g) Special rules for taxpayer identifying numbers issued to foreign persons--(1) General rule--(i) Social security number. A social security number is generally identified in the records and database of the Internal Revenue Service as a number belonging to a U.S. citizen or resident alien individual. A person may establish a different status for the number by providing proof of foreign status with the Internal Revenue Service under such procedures as the Internal Revenue Service shall prescribe, including the use of a form as the Internal Revenue Service may specify. Upon accepting an individual as a

nonresident alien individual, the Internal Revenue Service will assign this status to the individual's social security number.

(ii) Employer identification number. An employer identification number is generally identified in the records and database of the Internal Revenue Service as a number belonging to a U.S. person. However, the Internal Revenue Service may establish a separate class of employer identification numbers solely dedicated to foreign persons which will be identified as such in the records and database of the Internal Revenue Service. A person may establish a different status for the number either at the time of application or subsequently by providing proof of U.S. or foreign status with the Internal Revenue Service under such procedures as the Internal Revenue Service shall prescribe, including the use of a form as the Internal Revenue Service may specify. The Internal Revenue Service may require a person to apply for the type of employer identification number that reflects the status of that person as a U.S. or foreign person.

(iii) IRS individual taxpayer identification number. An IRS individual taxpayer identification number is generally identified in the records and database of the Internal Revenue Service as a number belonging to a nonresident alien individual. If the Internal Revenue Service determines at the time of application or subsequently, that an individual is not a nonresident alien individual, the Internal Revenue Service may

require that the individual apply for a social security number. If a social security number is not available, the Internal Revenue Service may accept that the individual use an IRS individual taxpayer identification number, which the Internal Revenue Service will identify as a number belonging to a U.S. resident alien.

(2) Change of foreign status. Once a taxpayer identifying number is identified in the records and database of the Internal Revenue Service as a number belonging to a U.S. or foreign person, the status of the number is permanent until the circumstances of the taxpayer change. A taxpayer whose status changes (for example, a nonresident alien individual with a social security number becomes a U.S. resident alien) must notify the Internal Revenue Service of the change of status under such procedures as the Internal Revenue Service shall prescribe, including the use of a form as the Internal Revenue Service may specify.

(3) Waiver of prohibition to disclose taxpayer information when acceptance agent acts. As part of its request for an IRS individual taxpayer identification number or submission of proof of foreign status with respect to any taxpayer identifying number, where the foreign person acts through an acceptance agent, the foreign person will agree to waive the limitations in section 6103 regarding the disclosure of certain taxpayer

information. However, the waiver will apply only for purposes of permitting the Internal Revenue Service and the acceptance agent to communicate with each other regarding matters related to the assignment of a taxpayer identifying number and change of foreign status.

(h) Effective date. The provisions of this section generally are effective for any return, statement, or other document to be filed after December 31, 1995. However, the provision of paragraph (a)(1)(ii) of this section that requires an estate to obtain an employer identification number applies on and after January 1, 1984.

Commissioner of Internal Revenue
Margaret Milner Richardson

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

FOR IMMEDIATE RELEASE
June 8, 1995

Contact: Chris Peacock
(202) 622-2960

TREASURY ANNOUNCES ALTERNATE STANDARD THAT PROTECTS FUNDS

The Treasury Department will include the Digital Signature Standard (DSS) on its Qualified Products List beginning July 1995.

The DSS is a new electronic standard that provides companies and individuals with a secure means of transferring electronic funds on the internet. It will conform to the federal government's current standard for information systems.

Treasury's Qualified Products List is made up of qualified signature products for electronically transferring funds. There are currently five signature products on the list.

Commercial vendors who would like to qualify for the list need to develop products that conform with the DSS for the list beginning July 1995. Vendors' products in accordance with the DSS require approval by Treasury's Office of Security.

For technical assistance, call Assistant Director for Systems Security Martin Ferris at (202) 622-1110.

-30-

RR-361

DEPARTMENT OF THE TREASURY

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FOR IMMEDIATE RELEASE
June 8, 1995

STATEMENT BY TREASURY SECRETARY ROBERT RUBIN

"U.S participation in the multilateral development banks (MDBs) is a critical element of United States foreign and economic policy. We are therefore seriously concerned about actions being taken in Congress to drastically reduce U.S. funding for these institutions. This will harm American standards of living, reduce our export opportunities, cost American jobs, and undermine our national security interests. These proposed reductions are short-sighted.

As I have stated in numerous speeches and in many formal and informal conversations with Congress, the MDBs are the most cost effective instruments we have to promote economic growth and policy reform in developing countries, Eastern Europe and the former Soviet Union and they have a long history of strong bipartisan support. Particularly alarming is the severe proposed reduction for the International Development Association (IDA), the key institution for integrating the very poorest countries into the global economy. In addition, it is important that the Congress fully fund U.S. commitments on debt reduction for these countries as well as the IMF's Enhanced Structural Adjustment Facility.

The Administration is fully committed to supporting IDA and other MDBs and we will work closely with the Congress in the months ahead to maintain support for these key institutions, which are vital to this country's economic and national security interests."

-30-

RR-362

DEPARTMENT OF THE TREASURY

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FOR IMMEDIATE RELEASE
Remarks as prepared for delivery
June 9, 1995

REMARKS OF TREASURY SECRETARY ROBERT E. RUBIN
GOVERNMENT REINVENTION EVENT

Mr. President, Mr. Vice President, special guests, ladies and gentlemen: Welcome to the Treasury Department, and thank you, Mr. President and Mr. Vice President, on behalf of our employees and families, for the support you have given us, especially our law enforcement people since the tragedy in Oklahoma City.

Let me tell our first-time guests a little something of the history of this building. Treasury has been located on this site since 1800, and has a proud history. The British burned the Treasury building in 1814. It was rebuilt, and I was told the employees burned the building in 1833. The current building has been in use since the Civil War. This room we are in, the Cash Room, is where the government used to transact its financial business.

I was in the private sector for 26 years and very familiar with Treasury's reputation for excellence. Mr. President, Mr. Vice President: I want you to know that in the five months I have been here I have been proud to work with a truly remarkable, capable and dedicated group of people -- the people of Treasury. They exemplify what the government service should be all about. Moreover, at Treasury, reinvention and customer service are becoming internalized and an integral part of our culture through the ranks. You can see that kind of commitment to customer service and change in the new IRS program which allows taxpayers to file their 1040 EZ Form information on a touch tone telephone. It's simple, it's easy, and the refund shows up more quickly. It's up and running in 12 states already, and next year we're taking it nationwide.

Customer service is a major element of reinvention, and every Treasury bureau now has published customer service plans. We're reducing regulations -- by 22 percent so far. We're streamlining, and Treasury has come down by a net of nearly 4,700 positions in two years. We've reformed our procurement process, made use of purchase cards and expanded the use of electronic commerce. We earned one of the Vice President's Hammer Awards for our procurement program. At Treasury, we promised better government and we are delivering.

RR-363 (MORE)

For press releases, speeches, public schedules and official biographies, call our 24-hour fax line at (202) 622-2040

RR-363

Today we're taking the next step. We have seven major initiatives in the second phase of Treasury reinvention -- each aimed at providing better service to our customers and making it easier for individuals and small businesses to deal with the government on Treasury-related issues.

The President will talk in detail about the initiatives we're highlighting today -- the Simplified Tax and Wage Reporting System, and the Federal/State Tax Partnership.

I want to mention the others because over time they too will make an important difference -- saving taxpayers and small businesses time, trouble and money, improving revenue collections, reducing the size of government and offering better service to tax filers. Those five initiatives are streamlining our field services; better coordinating our operations with other agencies that operate at our borders, improving debt collection, working on cards that provide electronic access to government benefits, and relentlessly looking for ways to operate more efficiently and so reduce our budget.

For years, in large measure, presidents said they would reform government, but produced only reports. This President is producing results.

A key reason is the commitment of the Vice President to translate reinvention from plans to action, as we at Treasury are doing today. He is in very large measure responsible for the new way we do business, not just in Treasury but throughout government. I'm pleased now to introduce Vice President Al Gore.

-30-

Small Business and the Simplified Tax and Wage Reporting System

Vision

- o The two-fold goal is: reduce employers time and expense in filing returns and paying taxes while saving Federal and state operations costs.

- o This is a voluntary system that:

    - Simplifies laws, definitions, and procedures related to tax and wage reporting (worker classification, wage components, data definitions, employer identification numbers, filing procedures and periods, forms and formats)

    - Through one-stop electronic filing, Federal and state governments will speak the same language, and businesses will spend less time filling out forms and more time creating jobs for Americans.

    - The Simplified Tax and Wage Reporting System will reduce red tape and costs to employers - especially small business - when they provide "W-2" tax and wage information.

- o When fully implemented, it can save employers up to almost $1 billion annually in tax and wage reporting costs. Of the approximately 6.2 million employers in the United States, 60 percent have fewer than five employees; therefore, small businesses, in particular, will benefit noticeably from reduced burdens.

Guiding Principles

- o Employers, States and Federal Agencies agree to:

    - Maintain the separation between Federal and state governments
    - Build on existing systems/programs (emphasize compatibility)
    - Protect employee benefit programs
    - Not impose additional cost
    - Protect privacy of participants.

Initial Progress - "Paper W-2 Project"

- o Under current practices, large employers (over 250 employees) submit magnetic tape containing all employers W-2 data to the Social Security Administration (SSA) and to the states. Small employers submit paper W-2 forms.

- Under the "Paper W-2 Project" begun in 1994, small employers send paper W-2's to SSA. SSA scans the paper, turns the data over to IRS which, in turn, sends tapes to 29 participating states, compiling the employer data for each state. The states are evaluating the usefulness of this approach to determine whether it will satisfy their needs for wage information. Illinois no longer requires employers to submit separate paper W-2 data; other states can do this if they choose to.

Scope

This will simplify reporting of:

- Federal and state tax and wage information
- State Unemployment Insurance (UI) tax and wage information
- UI tax payments
- Employer registration

Other Benefits

- Some of the benefits of the project are:
  - simpler wage and tax reporting requirements for the business community;
  - reduced number of contacts employers have with governmental entities;
  - reduction in employers' reporting costs;
  - improved accuracy and timeliness of data received -- allowing Federal and state agencies to better administer programs;
  - reduced duplication of effort at Federal and state levels; and
  - more efficient and state-of-the-art system (reducing Federal and state operating costs).

What Can Be Accomplished In The Short Run?

Under the Treasury Department's leadership:

- In 1995, the "Paper W-2 Project," was available nationwide and was expanded to 29 states from 12 states in 1994; it will be continued in 1996.

- In 1995, a prototype will be developed and by the end of 1996, employers will be able to submit all major reports (941, W-2 and state UI reports) electronically or on magnetic media. Small employers in participating states will be able to begin taking advantage of existing networks to file electronically.

- In 1995, Department of the Treasury and the Department of Labor will complete a detailed analysis of the state and Federal Unemployment Insurance programs to simplify them and determine required legislation.

FedState Partnerships Make Taxation Less Taxing

Vision

The IRS and state taxing authorities are working together to reduce taxpayer burden, improve taxpayer service, and minimize tax administration costs. The goal is to eliminate duplicative tax requirements and to take advantage of economies of scale in tax administration wherever possible.

Successes

- ***Joint Electronic Filing*** — Through a FedState joint electronic filing program, taxpayers can satisfy both their federal and state filing requirements with a single electronic transmission. 29 states participated in joint electronic filing in 1995, with more than 1.5 million returns filed. The program will expand to 32 states in 1996.
- ***Filing Assistance*** — The IRS and state tax agencies have worked together to jointly distribute tax forms and provide taxpayer filing assistance.
- ***Joint Outreach Programs*** — The IRS is working with many states to jointly provide:
  - -- tax counseling for the elderly,
  - -- education for new businesses,
  - -- education for other targeted taxpayer groups,
  - -- tax practitioners' workshops, and
  - -- educational publications.

Barriers

- Further growth in FedState partnership programs is hampered because the IRS is currently barred from using appropriated funds to provide services to state agencies, even if the cost is reimbursed.
- Because of present disclosure laws, a joint electronic filer must file in duplicate any tax data that is required by both the IRS and the state; the IRS then must transmit the second set of data to the state.

Removing Barriers

- To enhance the growth of FedState partnerships, we are working on a legislative proposal that would allow the IRS to use appropriated funds for FedState reimbursable projects and eliminate restrictions on the use of data that is common to both Federal and state tax returns.
- The legislation would serve as a model for states that need legislative changes to remove their barriers to growth in FedState partnerships. These proposals have been endorsed by the Federation of Tax Administrators representing all 50 states.

The Future

- Once the legal barriers are removed, the IRS and the states will be able to engage in countless new cooperative efforts that would make taxation less taxing by:

  -- eliminating the requirement that taxpayers provide the same information to both the IRS and the state taxing authorities;
  -- allowing taxpayers who make errors in their electronic returns to correct those errors by working with a single contact point for both Federal and state purposes;
  -- offering "one-stop service" where taxpayers could call one location and receive answers to federal, state, and local tax questions;
  -- allowing taxpayers to satisfy their tax obligations by entering into coordinated installment agreements with the IRS and state taxing agencies; and
  -- paving the way for the development of a single federal/state income tax form.

- The cost of government will be greatly reduced through eliminating duplicative tax administration efforts and taking full advantage of available economies of scale.

Increased Revenue and Burden Reduction

- Preliminary Treasury estimates, assuming participation by 20 percent of the states, show a cumulative benefit by FY 2000 of:

  --$1.5 billion reduction in taxpayer burden, and
  --$315 million increase in revenues.

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Let me tell our first-time guests a little something of the history of this building. Treasury has been located on this site since 1800, and has a proud history. The British burned the Treasury building in 1814. It was rebuilt, and I was told the employees burned the building in 1833. The current building has been in use since the Civil War. This room we are in, the Cash Room, is where the government used to transact its financial business.

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RR-363 (MORE)

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-30-

Highlights of the President's Plan To Restructure Cabinet Departments and Major Agencies; With Five Year Budget Savings

"Agency Reinvention"

Department of Energy ($14.10 billion in savings)

- Terminate the clean coal program, after completion of projects now underway.
- Privatize the Naval Petroleum Reserves in Elk Hills, CA.
- Sell uranium no longer needed for national defense purposes after rendering it suitable for commercial power reactors.
- Significantly reduce costs in DOE's applied research programs through requiring more cost-sharing and through cuts in lower priority programs.

Federal Emergency Management Agency ($100 million in savings)

- Integrate grant programs and consolidate funding streams, in order to enable states to better target FEMA funds for their particular needs.
- Encourage and provide incentives for states to establish State Disaster Trust Funds to enhance their own emergency management capabilities.
- Devolve Federal pre- and post-disaster mitigation responsibilities to state and local jurisdictions, while increasing state and local flexibility.
- Use Americorps and other national organizations' volunteers as outreach workers to supplement disaster assistance employees during presidentially-declared disasters.

General Services Administration ($1.4 billion in savings)

- Consider various forms of privatization, including the sale of business units and related assets to employees (ESOPs) or to private firms.
- Transfer virtually all other service functions and associated employees to the agencies.
- Encourage agencies to franchise activities to avoid duplication.
- Give the agencies expanded authority to acquire services and assets.
- Involve employee unions in designing and implementing details of this reinvention.

Department of Health and Human Services ($453 million in savings)

- Combine the Office of the Secretary and the Office of the Assistant Secretary for Health to eliminate an entire organizational layer of management.
- Consolidate 107 Public Health Service (PHS) activities into Performance Partnerships and consolidate grants to give states and local communities more flexibility.

- Merge two PHS agencies: the Agency for Toxic Substances and Disease Registry and the Centers for Disease Control and Prevention.

Department of Housing and Urban Development ($800 million in savings)

- It will consolidate some 60 programs into four:

  Housing Certificates for Families and Individuals
  Consolidates HUD's subsidized rental assistance programs (e.g. Section 8 Assistance and Vouchers) and support for public housing.

  Community Opportunity Fund
  Consolidates HUD's CDBG and other economic programs.

  Affordable Housing Fund
  Consolidates HOME (Housing for the Elderly and Disabled), Housing Counseling, National Homeownership Fund, Homeless programs, Housing for People with AIDS, and other housing production assistance programs.

  A New Entrepreneurial FHA
  The FHA will work with private enterprises and non-profits to expand homeownership opportunities to low and moderate income Americans, and provide decent, affordable housing to low-income renters.

Department of the Interior ($3.8 billion in savings)

- Eliminate the Office of Territorial and International Affairs.
- Transfer responsibilities for a significant number of Bureau of Reclamation facilities and terminate small reclamation programs.
- Eliminate the Minerals Management Service and transfer savings back to states.
- Allow offshore oil and gas royalty buyouts and forego complicated administrative processes.

National Aeronautics and Space Administration ($8 billion in savings)

- Restructure to eliminate duplication and overlapping capabilities.
- Privatize and commercialize (use private sector capabilities whenever possible).
- Return NASA to the role of a research and development agency.

Office of Personnel Management ($30 million in savings)

- Transform into an agency that supports a private-sector model for training, investigations, and staffing services to agencies.
- Agencies may perform these functions on their own, procure them from the private sector or from privatized OPM business units.

Small Business Administration ($1.2 billion in savings)

- Shift the financial burden of loan guaranty programs from the taxpayers to the beneficiaries by eliminating the government's current cost of 2.74 percent and imposing fees on the lenders and borrowers.
- Streamline field office structure by locating its 10 regional offices with the local district offices and consolidating district and satellite offices.
- Consolidate loan processing in several centers around the country and continue to centralize loan servicing.

Social Security Administration ($850 million savings)

- Stagger monthly payment dates, starting with new beneficiaries, throughout the month to eliminate workload spikes and allow SSA to provide better customer service without adding staff.
- Increase the number of recipients who are paid by direct deposit in three phases over next four years. By increasing this number, SSA would save $.35 per check, or $70 million per year and reduce the number of checks reported as lost each month.
- Stop collecting fees for attorneys or non-attorney representatives who appeal Social Security judgments. SSA currently withholds a part of past due benefits for the attorney.
- Require all employers, except those who employ only household workers, to file W-2 wage reports with SSA on magnetic media or by electronic transmission. This will eliminate the time and effort now spent in processing and checking paper.

Department of Transportation ($6.7 billion in savings)

- Transfer Federal Aviation Administration (FAA) air traffic control services to an "Air Traffic Corporation" to speed modernization and improve operating efficiency.
- Reorganize DOT's safety programs into a new Transportation Safety Administration.
- Consolidate 30 separate grants into a single transportation infrastructure grant (of more than $11 billion a year) for which highway, transit, passenger rail, and airport capital projects would be eligible, and allocate funds by formula to states and local jurisdictions.

Department of Veteran Affairs ($209 million savings)

- Reform the VA's medical care eligibility requirements, allowing VA to expand the range of outpatient services and replace unnecessary and more expensive inpatient hospital care, with more appropriate and less expensive ambulatory care.
- Replace the annual interview involving 93 questions, and another interview each time the veteran seeks care at a different VA facility with a simple check of IRS records to determine whether a veteran's reported taxable income qualifies him or her for free medical care.
- Integrate, consolidate, and privatize some of these ancillary support service like food preparation, housekeeping, engineering and maintenance, etc.
- Phase in the consolidation of the VA's two field offices for insurance operations.

Highlights of the President's Plan To Reinvent Regulatory Systems

Environmental Protection Agency (Regulatory)

- Reduce the overall reporting and record keeping burden of EPA rules with a 25% decrease of paperwork.
- Provide incentives for self-disclosure and correction.
- Allow state, tribal, and local recipients of EPA grants to combine over $600 million in air, water and waste grants. That flexibility will give them the ability to find cleaner and cheaper means of achieving their local environmental goals.

Food and Drug Administration (Regulatory)

- Allow manufacturing changes without FDA pre-approval.
- Eliminate some special drug requirements on insulin and antibiotics.
- Exempt up to 138 categories of low-risk medical devices from pre-market review (i.e. syringes or oxygen masks).
- Eliminate virtually all environmental assessments for human drugs and biologics and animal drugs.
- Harmonize international standards for the review of drugs and medical devices.

General Reform: small business (Regulatory)

- Waive fines for small businesses that have acted properly but violated the rules. In this way, business owners can put their energies into correcting problems, not fighting with regulators.

Occupational Safety and Health Agency (Regulatory)

- Nationalize the "Maine 200" program, which creates a partnership between companies and OSHA regulators to dramatically improve worker health and safety.
- Adopt "Quick Fix" incentives for fixing hazards quickly. Using this model, compliance officers reduce penalties for violations that are abated during the inspection, encouraging employers to increase employee protection immediately while reducing follow-up work.
- Begin "focused inspections" for employers with strong and effective safety and health programs. OSHA will conduct an inspection limited to the top four hazards that kill workers in the construction industry.

THE EFFECT OF REGULATIONS ON THE SMALL ENTREPRENEUR

- According to Small Business Administration surveys, the smallest of the small firms are nearly unanimous in their animosity toward the burden of tax compliance paperwork and payroll recordkeeping.

- Companies with under 10 employees represent the vast majority of the American economy - almost 80%.

- Micro-small businesses, firms with 1-4 employees, spend as much as $32,000 per employee to comply with regulations.

- In comparison, larger companies experience an average cost of $17,000 per employee.

- Firms with under 10 employees indicate that about 47% of their total regulatory burden is tax-related with about 32% being payroll-related.

- Contrast this with large firms (over 500 employees) where only 26% of the burden is tax-related and 22% is payroll related.

- Small entrepreneurs surveyed believe that a reduced regulatory burden (simplified reporting requirements) could result in a 21 to 35% change in the amount of time and effort they spend complying.

MEMORANDUM OF UNDERSTANDING
AMONG THE
INTERNAL REVENUE SERVICE,
SOCIAL SECURITY ADMINISTRATION
AND
U.S. DEPARTMENT OF LABOR

BACKGROUND

The Internal Revenue Service (IRS) in the Department of the Treasury, the Social Security Administration (SSA) and the Department of Labor are each participating in a project to identify and pursue ways to improve the nation's wage and tax reporting system. The project is known as the Simplified Tax and Wage Reporting System (STAWRS).

The objective of each agency's participation in STAWRS is to reduce the tax and wage reporting burden on employers while improving the efficiency and effectiveness of each agency's operations. This objective is being pursued by: 1) exploring the feasibility of, and making available, a variety of tax and wage reporting services to employers and participating tax entities, as appropriate, and 2) developing a harmonized wage code which will bring into agreement the Federal and State definitions of wages and other terms, due dates, forms and reporting formats relating to wage and tax reporting (to the extent practical), and the employer identification numbering system.

Vice President Gore's National Performance Review (NPR) recommended pursuing this initiative in the September 7, 1993 Report, "From Red Tape to Results, Creating a Government that Works Better & Costs Less." The NPR included STAWRS in two recommendations: TRE05, "Simplify Employer Wage Reporting," and IT05, "Provide Intergovernmental Tax Filing, Reporting, and Payments Processing."

In another Memorandum of Understanding (MOU), the Secretary of the Treasury, the Commissioner of Social Security, and the Secretary of Labor acknowledged the importance to each agency of reducing the tax and wage reporting burden and agreed to pursue the STAWRS objectives in a coordinated fashion. That MOU also established an Executive Steering Committee, comprised of senior representatives from the Internal Revenue Service, the Social Security Administration, and the Department of Labor.

PURPOSE

The purpose of this MOU is to implement the objectives of the MOU referenced above by establishing a STAWRS Project Office. The Internal Revenue Service will establish the STAWRS Project Office. Agency liaison representatives from SSA and the Department of Labor will coordinate the efforts of their respective agencies through the STAWRS Project Office. STAWRS Project Office staff and SSA and Department of Labor liaison representatives will work closely with each other and with their respective associated stakeholders to achieve the Project's objectives. The STAWRS Project Office will establish a facility appropriate for the extensive collaboration efforts contemplated by the three agencies and for the broad-based stakeholder consultation envisioned under these MOU's.

ESTABLISHMENT OF STAWRS PROJECT OFFICE

1. An Executive-In-Charge, designated by the Assistant Secretary for Management in the Department of the Treasury, will lead the STAWRS Project Office.

2. The Commissioner of the IRS will provide a minimum of two full-time equivalents to serve in the STAWRS Project Office. The Commissioner of Social Security and the Deputy Secretary of Labor will each provide a minimum of two full-time equivalents to serve as agency liaison representatives to the STAWRS Project. All commitments of staff are subject to the availability of funds and are for the initial 36 months following the signing of this MOU, or less, if the project is terminated earlier. SSA and the

Department of Labor will, subject to the availability of funds, assume the costs associated with the participation of their respective liaison representatives.

3. STAWRS Project Office staff and SSA and DOL agency liaison representatives to the STAWRS Project may work at their official duty stations, or the STAWRS Project Office when direct collaboration is necessary to carry out their duties.

4. The responsibilities of the STAWRS Project Office include: identifying, implementing, and evaluating proof-of-concept pilot and demonstration projects; establishing and operating a stakeholder relations and education program; drafting proposed legislation, regulations, orders, agreements, procedures, and related documents; developing and analyzing alternatives for STAWRS management organizations; drafting a model harmonized wage code; developing, evaluating, and recommending privacy, disclosure, and data sharing policies; drafting simplified forms and filing procedures; developing proposed operational policies and procedures; and performing other related duties. Agency liaison activities will include having agency employees develop positions on STAWRS Project issues related to their respective agency's mission. Each agency's representatives will ensure that proposed positions are communicated to and coordinated with the affected agencies.

5. The STAWRS Project Office will actively seek advice and recommendations from individual stakeholders, including representatives from States, State and Federal Government organizations, employers, employer organizations, labor organizations, employees, privacy advocates, and from the public, as necessary.

6. In addition to the staff provided in paragraph 2, the IRS will provide, subject to the availability of funds, reasonably appropriate office facilities, conference rooms, equipment, supplies, and related support services and clerical staff for the day-to-day operation of the STAWRS Project Office.

7. The IRS will provide, subject to the availability of funds, reasonably necessary communications facilities. These may include an 800 number and a PC-based bulletin board to ensure full project participation by all stakeholders including Federal agencies, State Governments, employers, employer representatives, employee organizations, and privacy advocates.

AUTHORITIES

(1) Title 42 of the United States Code (U.S.C.) Under Title XI of the Social Security Act, the Secretary of the Treasury and the Secretary of Labor make the necessary rules and regulations for the efficient administration of the functions with which each agency is charged under the Social Security Act (42 U.S.C. 1302). Under Titles II and VII of the Social Security Act, the Commissioner of Social Security is authorized to prescribe such rules and regulations as the Commissioner determines necessary or appropriate to carry out SSA's functions and may establish such procedures as the Commissioner determines necessary and appropriate to carry out the provisions of Title II (42 U. S. C. 405(a) and 902(a)(5)).

Title II of the Social Security Act authorizes the Secretary of the Treasury and the Commissioner of Social Security to enter into an agreement to process tax information under a Combined Annual Wage Reporting System (42 U.S.C. 432). The law authorizes the Secretary of the Treasury and the Commissioner of Social Security to modify or change the manner of such processing by mutual agreement.

The Commissioner of Social Security also must establish and maintain records of the amounts of each individual's earnings from employment and self-employment and the periods in which such amounts were earned (42 U. S. C. 405(c)(2)(A)).

(2) Title 31 of the U.S.C. The Secretary of the Treasury has responsibility for preparing plans for improving and managing receipts of the United States Government

(31 U.S.C. 321).

(3) Title 29 of the U.S.C. The Secretary of Labor has the responsibility to foster, promote, and develop the welfare of the wage earners of the United States, to improve their working conditions, and to advance their opportunities for profitable employment (29 U.S.C. 551).

(4) Title 26 of the U.S.C. The Commissioner of the IRS has been given authority for administration and enforcement of the Internal Revenue laws by the Secretary of the Treasury in the Department of the Treasury Order No. 150-10. This includes authority over employment taxes (Subtitle C and F, 26 U.S.C.).

PARTIES TO THE AGREEMENT

The parties to this MOU are the Internal Revenue Service, the Social Security Administration, and the Department of Labor. This agreement shall continue to apply to any entity of the United States Government which is a successor in interest to any Executive Agency which is a party to this agreement.

EFFECT OF AGREEMENT ON OTHER PERSONS AND OTHER AGREEMENTS

This document is an internal Government agreement and is not intended to confer any right or benefit on any private person or party.

Nothing in this agreement shall be interpreted as limiting, superseding, or otherwise affecting an agency's normal operations or decisions in carrying out its regulatory or legal duties. This MOU is not intended to replace, limit, supersede, or otherwise affect other agreements among or between the agencies except to the extent necessary for proper implementation of this agreement.

EFFECTIVE DATE AND AMENDMENT

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We, the undersigned, do hereby agree with the foregoing provisions of this agreement.

______________________	__________
Deputy Secretary Department of Labor	Date
______________________	__________
Commissioner Internal Revenue Service	Date
______________________	__________
Commissioner Social Security Administration	Date

Witnessed by:

________________________________ ______________________

Small Business Owner | Date

MEMORANDUM OF UNDERSTANDING
AMONG THE
INTERNAL REVENUE SERVICE,
SOCIAL SECURITY ADMINISTRATION
AND
U.S. DEPARTMENT OF LABOR

BACKGROUND

The Internal Revenue Service (IRS) in the Department of the Treasury, the Social Security Administration (SSA) and the Department of Labor are each participating in a project to identify and pursue ways to improve the nation's wage and tax reporting system. The project is known as the Simplified Tax and Wage Reporting System (STAWRS).

The objective of each agency's participation in STAWRS is to reduce the tax and wage reporting burden on employers while improving the efficiency and effectiveness of each agency's operations. This objective is being pursued by: 1) exploring the feasibility of, and making available, a variety of tax and wage reporting services to employers and participating tax entities, as appropriate, and 2) developing a harmonized wage code which will bring into agreement the Federal and State definitions of wages and other terms, due dates, forms and reporting formats relating to wage and tax reporting (to the extent practical), and the employer identification numbering system.

Vice President Gore's National Performance Review (NPR) recommended pursuing this initiative in the September 7, 1993 Report, "From Red Tape to Results, Creating a Government that Works Better & Costs Less." The NPR included STAWRS in two recommendations: TRE05, "Simplify Employer Wage Reporting," and IT05, "Provide Intergovernmental Tax Filing, Reporting, and Payments Processing."

In another Memorandum of Understanding (MOU), the Secretary of the Treasury, the Commissioner of Social Security, and the Secretary of Labor acknowledged the importance to each agency of reducing the tax and wage reporting burden and agreed to pursue the STAWRS objectives in a coordinated fashion. That MOU also established an Executive Steering Committee, comprised of senior representatives from the Internal Revenue Service, the Social Security Administration, and the Department of Labor.

PURPOSE

The purpose of this MOU is to implement the objectives of the MOU referenced above by establishing a STAWRS Project Office. The Internal Revenue Service will establish the STAWRS Project Office. Agency liaison representatives from SSA and the Department of Labor will coordinate the efforts of their respective agencies through the STAWRS Project Office. STAWRS Project Office staff and SSA and Department of Labor liaison representatives will work closely with each other and with their respective associated stakeholders to achieve the Project's objectives. The STAWRS Project Office will establish a facility appropriate for the extensive collaboration efforts contemplated by the three agencies and for the broad-based stakeholder consultation envisioned under these MOU's.

ESTABLISHMENT OF STAWRS PROJECT OFFICE

1. An Executive-In-Charge, designated by the Assistant Secretary for Management in the Department of the Treasury, will lead the STAWRS Project Office.

2. The Commissioner of the IRS will provide a minimum of two full-time equivalents to serve in the STAWRS Project Office. The Commissioner of Social Security and the Deputy Secretary of Labor will each provide a minimum of two full-time equivalents to serve as agency liaison representatives to the STAWRS Project. All commitments of staff are subject to the availability of funds and are for the initial 36 months following the signing of this MOU, or less, if the project is terminated earlier. SSA and the

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________________________	_________
Deputy Secretary Department of Labor	Date
________________________	_________
Commissioner Internal Revenue Service	Date
________________________	_________
Commissioner Social Security Administration	Date

Witnessed by:

Small Business Owner

Date

Paul Condit
Profile
Seminole, Texas

Paul Condit and his wife, Patsy, have three sons, John, Jim and Jeff. All three sons are college graduates.

Paul Condit was born in Foster, Oklahoma. He is a graduate of Oklahoma A&M College.

Mr. Condit has farmed in Gaines County , Texas for 29 years. During that time he owned and operated a chemical company and a farm implement dealership. He has served as ASCS committee chairman, director of the Seminole Chamber of Commerce, and as president of the Seminole Hospital Board.

Mr. Condit is currently serving on the Seminole Hospital Board and as Chairman of the Gaines County Democratic Party

He is the General Manager and President of Texas Equipment Company, the second largest John Deere Dealership in the state of Texas. Texas Equipment Company has 58 employees in three locations and total sales of over $20 million.

THE WHITE HOUSE
OFFICE OF THE PRESS SECRETARY

FOR IMMEDIATE RELEASE
FRIDAY, June 9, 1995

CONTACT: 202-456-7035

PRESIDENT CLINTON REDUCES BURDEN ON SMALL BUSINESS, INDIVIDUALS
Announces Single Filings To Streamline Reporting Requirements of Employers, Taxpayers

WASHINGTON -- With the goal of reducing government's burden on small business owners and individuals, President Clinton and Vice President Gore today (6/9) announced initiatives that will significantly streamline wage and income reporting requirements and eventually lead to a system of single electronic filing with federal and state governments..

"For years, small and big businesses, and concerned citizens across this country, have been telling Washington to 'get real' about the absurd, frustrating, and costly paperwork burdens that have been placed on them. The system that's set up now is very convenient for the government. Now it's the government's turn to be convenient for business owners and taxpayers," the President said.

The Vice President said, "We are getting rid of management practices and structures that were right for the industrial age, and bringing things up-to-date with the information age. We are taking quality lessons from America's best run businesses."

Joined by Department of Treasury Secretary Robert Rubin, Department of Labor Deputy Secretary Thomas Glynn, Social Security Administration Commissioner Shirley Chater, and Internal Revenue Service Commissioner Margaret Richardson, as well as delegates from the White House Conference on Small Business, the President outlined two proposals aimed at reducing the burden on small business owners and individuals when reporting wages and income to the federal and state governments:

The Small Business and Simplified Tax and Wage Reporting System (STAWRS) will simplify tax compliance and payroll recordkeeping regulations, judged the most burdensome concern of businesses with 10 or fewer employees -- or about 79 percent of American businesses. The initiative will eventually enable employers to file W-2 data through single returns electronically with both the federal and state governments, and simplifies the laws, definitions and procedures related to tax and wage reporting.

(MORE)

Treasury Secretary Rubin, Deputy Labor Secretary Glynn, SSA Commissioner Chater, and IRS Commissioner Richardson signed a Memorandum of Understanding to implement this initiative, which, when fully implemented, is expected to save employers about $1 billion annually in tax and wage reporting costs.

FedState Partnership programs will further eliminate duplicative tax requirements and eventually allow taxpayers to satisfy both their federal and state filing obligations with a single electronic transmission. The initiative also calls for the Internal Revenue Service (IRS) and state tax agencies to work together to provide taxpayers filing assistance and enhance outreach educational programs for the elderly, new business owners and other groups.

Twenty-nine states participated in joint electronic filing in 1995, and the program will expand to 32 states in 1996. The President announced he will send legislation to Congress to allow further growth in the FedState Partnership programs, which is now hampered by current disclosure and appropriation laws between the federal government and the states. The initiative is estimated to reduce the burden to taxpayers by $1.5 billion.

Secretary Rubin said, "For years, prior Presidents said they would reform government, but they produced only reports. President Clinton is producing results."

Today's announcement is part of the second phase of the National Performance Review (NPR), which already has saved more than $63 billion of NPR's $108 billion in proposed savings, and resulted in the reduction of more than 102,000 FTEs of 272,000 FTEs targeted over five years.

##

Making it E-Z-er For the Taxpayer

People and businesses have been spending too much time and money answering the same tax and wage questions asked by different government agencies. President Clinton launched a plan today that will help stop that duplication.

RELIEVING DUPLICATE FILING BURDEN ON EMPLOYERS

President Clinton presided over the signing of an agreement among the heads of the Treasury Department, the Internal Revenue Service, the Department of Labor and the Social Security Administration that commits those agencies to work together with State agencies to eliminate duplicate tax data filing requirements on businesses and taxpayers.

For example, under current practices, large employers submit magnetic tape containing all employers W-2 data to the Social Security Administration and the same information to the states in which they do business. Small employers file similar duplicate information but in paper W-2 forms. This duplicate Federal and State filing can be eliminated if the federal and state agencies do what the President is asking be done in partnership. Small employers who file a paper W-2 form can have the Social Security Administration scan the paper and turn the data over to the IRS which, in turn, sends tape of the data to states participating in this new partnership. The state and federal agencies will maintain their separate taxing jurisdiction, but will be able to cut costs and provide better service to the taxpayer by sharing data that is duplicative, and by providing the taxpayer with one stop customer service. Some of the benefits of this Simplified Wage and Tax Reporting System are:

1) simpler wage and tax reporting requirements for the business community;

2) reduced number of contacts employers have with government entities;

3) reduction in employers' reporting costs;

4) improved accuracy and timelines of data received -- allowing Federal and state agencies to better administer programs;

5) reduced duplication of effort at Federal and state levels; and

6) more efficient and state-of-the-art system (reducing Federal and state operating costs).

Pursuant to the Agreement among the Federal agencies, a prototype will be developed and by the end of 1996, employers will be able to submit all major reports (Forms 941, W-2 and State Unemployment Insurance Reports) electronically or on magnetic media.

RELIEVING THE BURDEN ON ALL TAXPAYERS

President Clinton further announced that he will be sending legislation to Congress shortly to pave the way for joint projects between Federal and State agencies that will make taxation less taxing by:

- -- eliminating the requirements that taxpayers provide the same information to both the IRS and the state taxing authorities;
- -- allowing taxpayers who make errors in their electronic returns to correct those errors by working with a single contact point for both Federal and state purposes;
- -- offering "one-stop service" where taxpayers could call one location and receive answers to federal, state, and local tax questions;
- -- allowing taxpayers to satisfy their tax obligations by entering into coordinated installment agreements with the IRS and state taxing agencies; and
- -- paving the way for the development of a single federal/state income tax form.

The cost of government will be greatly reduced through eliminating duplicative tax administration efforts and taking full advantage of available economies of scale.

Preliminary Treasury estimates, assuming participation by 20 percent of the states -- which is expected to be much greater -- show a cumulative benefit by FY 2000 of $1.5 billion reduction in taxpayer burden.

MORE REINVENTION

Treasury Secretary Robert Rubin listed other Treasury commitments to improve how Treasury does its business:

1. Streamlining Treasury Field Offices;
2. Improving enforcement of border operations;
3. Consolidating administrative services that yield savings and produce better service.
4. Improving collection of delinquent debt owned to the Federal government.
5. Assisting in the use of Smart Cards

Preliminary estimates show that all of these initiatives of the National Performance Review (Phase II) have potential in the next five years for:

- --- $1-3 billion additional revenue;
- --- $500 million cost savings;
- --- $3 billion reduced taxpayer burden;
- --- streamlining workforce by 4000;
- --- and better service for tax filers and travellers.

- end -

Small Business and the Simplified Tax and Wage Reporting System

Vision

- The two-fold goal is: reduce employers time and expense in filing returns and paying taxes while saving Federal and state operations costs.

- This is a voluntary system that:

  - Simplifies laws, definitions, and procedures related to tax and wage reporting (worker classification, wage components, data definitions, employer identification numbers, filing procedures and periods, forms and formats)

  - Through one-stop electronic filing, Federal and state governments will speak the same language, and businesses will spend less time filling out forms and more time creating jobs for Americans.

  - The Simplified Tax and Wage Reporting System will reduce red tape and costs to employers - especially small business - when they provide "W-2" tax and wage information.

- When fully implemented, it can save employers up to almost $1 billion annually in tax and wage reporting costs. Of the approximately 6.2 million employers in the United States, 60 percent have fewer than five employees; therefore, small businesses, in particular, will benefit noticeably from reduced burdens.

Guiding Principles

- Employers, States and Federal Agencies agree to:

  - Maintain the separation between Federal and state governments
  - Build on existing systems/programs (emphasize compatibility)
  - Protect employee benefit programs
  - Not impose additional cost
  - Protect privacy of participants.

Initial Progress - "Paper W-2 Project"

- Under current practices, large employers (over 250 employees) submit magnetic tape containing all employers W-2 data to the Social Security Administration (SSA) and to the states. Small employers submit paper W-2 forms.

- o Under the "Paper W-2 Project" begun in 1994, small employers send paper W-2's to SSA. SSA scans the paper, turns the data over to IRS which, in turn, sends tapes to 29 participating states, compiling the employer data for each state. The states are evaluating the usefulness of this approach to determine whether it will satisfy their needs for wage information. Illinois no longer requires employers to submit separate paper W-2 data; other states can do this if they choose to.

Scope

This will simplify reporting of:

- Federal and state tax and wage information
- State Unemployment Insurance (UI) tax and wage information
- UI tax payments
- Employer registration

Other Benefits

o Some of the benefits of the project are:

- simpler wage and tax reporting requirements for the business community;
- reduced number of contacts employers have with governmental entities;
- reduction in employers' reporting costs;
- improved accuracy and timeliness of data received -- allowing Federal and state agencies to better administer programs;
- reduced duplication of effort at Federal and state levels; and
- more efficient and state-of-the-art system (reducing Federal and state operating costs).

What Can Be Accomplished In The Short Run?

Under the Treasury Department's leadership:

o In 1995, the "Paper W-2 Project," was available nationwide and was expanded to 29 states from 12 states in 1994; it will be continued in 1996.

o In 1995, a prototype will be developed and by the end of 1996, employers will be able to submit all major reports (941, W-2 and state UI reports) electronically or on magnetic media. Small employers in participating states will be able to begin taking advantage of existing networks to file electronically.

o In 1995, Department of the Treasury and the Department of Labor will complete a detailed analysis of the state and Federal Unemployment Insurance programs to simplify them and determine required legislation.

FedState Partnerships Make Taxation Less Taxing

Vision

The IRS and state taxing authorities are working together to reduce taxpayer burden, improve taxpayer service, and minimize tax administration costs. The goal is to eliminate duplicative tax requirements and to take advantage of economies of scale in tax administration wherever possible.

Successes

- ***Joint Electronic Filing*** — Through a FedState joint electronic filing program, taxpayers can satisfy both their federal and state filing requirements with a single electronic transmission. 29 states participated in joint electronic filing in 1995, with more than 1.5 million returns filed. The program will expand to 32 states in 1996.
- ***Filing Assistance*** — The IRS and state tax agencies have worked together to jointly distribute tax forms and provide taxpayer filing assistance.
- ***Joint Outreach Programs*** — The IRS is working with many states to jointly provide:
  - -- tax counseling for the elderly,
  - -- education for new businesses,
  - -- education for other targeted taxpayer groups,
  - -- tax practitioners' workshops, and
  - -- educational publications.

Barriers

- Further growth in FedState partnership programs is hampered because the IRS is currently barred from using appropriated funds to provide services to state agencies, even if the cost is reimbursed.
- Because of present disclosure laws, a joint electronic filer must file in duplicate any tax data that is required by both the IRS and the state; the IRS then must transmit the second set of data to the state.

Removing Barriers

- To enhance the growth of FedState partnerships, we are working on a legislative proposal that would allow the IRS to use appropriated funds for FedState reimbursable projects and eliminate restrictions on the use of data that is common to both Federal and state tax returns.
- The legislation would serve as a model for states that need legislative changes to remove their barriers to growth in FedState partnerships. These proposals have been endorsed by the Federation of Tax Administrators representing all 50 states.

The Future

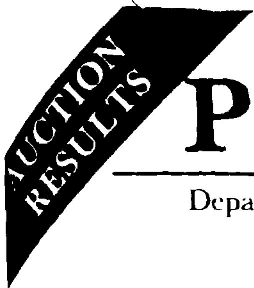
- Once the legal barriers are removed, the IRS and the states will be able to engage in countless new cooperative efforts that would make taxation less taxing by:
  - -- eliminating the requirement that taxpayers provide the same information to both the IRS and the state taxing authorities;
  - -- allowing taxpayers who make errors in their electronic returns to correct those errors by working with a single contact point for both Federal and state purposes;
  - -- offering "one-stop service" where taxpayers could call one location and receive answers to federal, state, and local tax questions;
  - -- allowing taxpayers to satisfy their tax obligations by entering into coordinated installment agreements with the IRS and state taxing agencies; and
  - -- paving the way for the development of a single federal/state income tax form.

- The cost of government will be greatly reduced through eliminating duplicative tax administration efforts and taking full advantage of available economies of scale.

Increased Revenue and Burden Reduction

- Preliminary Treasury estimates, assuming participation by 20 percent of the states, show a cumulative benefit by FY 2000 of:

  --$1.5 billion reduction in taxpayer burden, and
  --$315 million increase in revenues.



PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR IMMEDIATE RELEASE
June 12, 1995

CONTACT: Office of Financing
202-219-3350

JUN 20 95 0029 35

RESULTS OF TREASURY'S AUCTION OF 13-WEEK BILLS

Tenders for $14,308 million of 13-week bills to be issued June 15, 1995 and to mature September 14, 1995 were accepted today (CUSIP: 912794U85).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.55%	5.72%	98.597
High	5.57%	5.74%	98.592
Average	5.57%	5.74%	98.592

Tenders at the high discount rate were allotted 36%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

	Received	Accepted
TOTALS	$50,764,576	$14,307,790
Type		
Competitive	$45,277,602	$8,820,816
Noncompetitive	1,384,594	1,384,594
Subtotal, Public	$46,662,196	$10,205,410
Federal Reserve	3,308,380	3,308,380
Foreign Official Institutions	794,000	794,000
TOTALS	$50,764,576	$14,307,790

5.56--98.595

RR-364

AUCTION RESULTS

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

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DEPT. OF THE TREASURY

FOR IMMEDIATE RELEASE
June 12, 1995

CONTACT: Office of Financing
202-219-3350

RESULTS OF TREASURY'S AUCTION OF 26-WEEK BILLS

Tenders for $14,275 million of 26-week bills to be issued June 15, 1995 and to mature December 14, 1995 were accepted today (CUSIP: 912794T61).

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate	Price
Low	5.55%	5.81%	97.194
High	5.56%	5.82%	97.189
Average	5.56%	5.82%	97.189

Tenders at the high discount rate were allotted 89%.
The investment rate is the equivalent coupon-issue yield.

TENDERS RECEIVED AND ACCEPTED (in thousands)

	Received	Accepted
TOTALS	$45,822,918	$14,275,166
Type		
Competitive	$39,174,770	$7,627,018
Noncompetitive	1,228,348	1,228,348
Subtotal, Public	$40,403,118	$8,855,366
Federal Reserve	3,350,000	3,350,000
Foreign Official Institutions	2,069,800	2,069,800
TOTALS	$45,822,918	$14,275,166

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS • 1500 PENNSYLVANIA AVENUE, N.W. • WASHINGTON, D.C. • 20220 • (202) 622-2960

FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m. EDT
June 13, 1995

STATEMENT OF
DEPARTMENT OF THE TREASURY
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
BEFORE THE
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

Mr. Chairman and members of the Committee, I am pleased today to recommend, on behalf of the Administration, favorable action on seven bilateral tax treaties and protocols that the President has transmitted to the Senate and that are the subject of this hearing. My colleague, Mr. Joseph H. Guttentag, will discuss one of these agreements, the Protocol to the Income Tax Convention with Mexico. These agreements each would provide significant benefits to the United States, and the Treasury hopes that the Senate will take prompt and favorable action on all of these agreements.

The treaties and protocols before the Committee today represent a cross-section of the United States tax treaty program. There are agreements with two of our largest trading partners -- Canada and France. Two are with smaller, but nevertheless significant partners -- Sweden and Portugal. There also are two treaties with countries that are likely to become significant trading partners in the future -- Kazakhstan and Ukraine. Each agreement will generate substantial benefits for U.S. taxpayers and tax authorities, and will serve to increase desirable international economic activity.

To help frame our discussions, I would like to describe in general terms the U.S. tax treaty program. The United States has a network of 47 bilateral income tax treaties, the first of which was negotiated in 1939. We have treaties with most of our significant trading partners. With the exceptions of Portugal and Turkey, we have treaties in force with all 24 of our fellow members of the Organization for Economic Cooperation and Development (OECD).

The Treasury Department receives regular and numerous requests to enter tax treaty negotiations. As a result it has been necessary for us to establish priorities. These priorities are not new: they are reflected in the treaties that the Senate approved in 1993 as well as the treaties that you are considering today.

In response to prior direction from the Senate as well as the Treasury's own policies, the Treasury's first priority for treaty

RR-366

negotiations is to renegotiate outdated treaties that lack effective anti-abuse clauses and that do not reflect recent changes in U.S. tax legislation. Examples in this category are the agreements with Canada, France and Sweden. Other treaties in this category that are currently being renegotiated include Austria, Luxembourg and Switzerland. We have made it clear to our treaty partners that we will not tolerate continuation of treaty relationships that fail to reflect important U.S. treaty policies.

A second priority is to conclude treaties that are likely to provide the greatest benefits to U.S. taxpayers. As discussed below, these benefits are important to the competitive posture of U.S. taxpayers that enter a treaty partner's marketplace. Such treaties could include treaties with expanding economies with which we lack a treaty, or revised treaties with existing treaty partners but that contain substantially improved provisions. Examples in this category include the treaty with Portugal, as well as the agreements with Canada and France.

A third priority is to conclude treaties with countries with which we lack a treaty, but that have the potential to be significant trading partners. The list of such countries has always been a long one, and it has become even longer since the late 1980's and the opening of the Iron Curtain. Therefore it has become necessary to consider additional factors in setting priorities among this category. One such factor is the international economic and foreign policy of the United States. Treasury tries to focus its efforts in this category on those countries with which strong political and economic relations are a high priority. The existence of a tax treaty can help remove impediments to trade and investment in such countries and thereby help establish economic ties that may contribute to the country's stability and independence. Consideration of this factor is not new. In 1993 the Senate considered and approved treaties with three countries that fit this description: the Russian Federation, the Czech Republic, and Slovakia. The treaties before you today contain two examples from this category: Ukraine and Kazakhstan.

Benefits Provided by Income Tax Treaties

Irrespective of the category in which a particular country may fall, we seek to achieve the same two basic objectives through the treaty. First, it reduces income tax-related barriers to international trade and investment. An active treaty program is a significant element in the overall international economic policy of the United States. A tax treaty has a substantial positive impact on the competitive position of U.S. businesses that enter a treaty partner's marketplace.

A second general objective of our tax treaty program is to combat tax avoidance and evasion. A treaty provides the tax

administrations of both treaty partners with certain tools with which to combat tax evasion.

While the domestic tax legislation of the United States and many other countries in many ways is intended to further the same general objectives as our treaty program, a treaty network goes beyond what domestic legislation can achieve. Legislation is by its nature unilateral and cannot easily distinguish among countries. It cannot take into account other countries' rules for the taxation of particular classes of income, and how those rules interact with U.S. statutory rules. Legislation also cannot reflect variations in the United States' bilateral relations with our treaty partners. A treaty, on the other hand, can make useful distinctions, and alter, in an appropriate manner, domestic statutory law as it applies to income flowing between the treaty partners.

Benefits to Taxpayers

An income tax treaty removes impediments to international trade and investment in three ways. First, it reduces the withholding taxes on flows of investment income that the United States and most other countries impose. Second, it establishes rules that assign to one country or the other the primary right of taxation with respect to an item of income, helping to prevent "double taxation," which occurs when both countries impose tax on the same income. Third, the treaty provides a dispute resolution mechanism to prevent double taxation that sometimes can arise in spite of the treaty. These and other benefits provided by a tax treaty help to minimize the effects of tax considerations on investment location decisions, facilitating the cross-border flows of trade, services and technology. I would like to briefly discuss each of these aspects of an income tax treaty.

High withholding taxes are an impediment to international investment. Under United States domestic law, all payments to non-U.S. persons of dividends and royalties and certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Since this tax is imposed on a gross rather than net amount, it imposes a high cost on investors receiving such payments. Indeed, in many cases the cost of such taxes can be prohibitive. Most of our trading partners impose similar levels of withholding tax on these types of income.

Tax treaties remove this burden by reducing the levels of withholding tax that the treaty partners may impose on these types of income. In general, U.S. policy is to reduce the rate of taxation on interest and royalties to zero. Dividends normally are subject to tax at one of two rates, depending on the amount of stock that the recipient owns in the company distributing the dividend. If the recipient is a corporation owning a significant percentage of shares in the distributing company -- usually 10

percent -- the rate of tax is usually limited to 5 percent. In all other cases the tax is generally limited to 15 percent.

The extent to which this policy is realized depends on a number of factors. Although generalizations often are difficult to make in the context of complex negotiations, it is fair to say that we are more successful in reducing these rates with countries that are relatively developed and where there are substantial reciprocal flows. We also achieve lesser, but still very significant reductions with countries where the flows tend to be disproportionately in favor of the United States. In the latter case, the treaty partner may perceive that it is making a concession in favor of the United States without receiving a corresponding benefit. For this reason and others the withholding rates tend to vary somewhat from treaty to treaty. All treaties, however, achieve substantial reductions in withholding taxes.

Eliminating double taxation is another paramount objective of any income tax treaty. One of the principal ways this is achieved is through assignment of primary taxing jurisdiction in particular factual settings to one treaty partner or the other. In the absence of a treaty, a U.S. company operating a branch or division or providing services in another country might be subject to income tax in both countries on the income generated by such operations. The resulting double taxation can impose an oppressive financial burden on the operation and might well make it economically unfeasible.

The tax treaty lays out ground rules providing that one country or the other, but not both, will have primary taxing jurisdiction over branch operations and individuals performing services. In general terms, the treaty provides that if the branch operations have sufficient substance and continuity, the country where the activities occur will have primary jurisdiction to tax. In other cases, where the operations are relatively minor, the home country retains the primary jurisdiction to tax. These provisions are especially important in treaties with less-developed countries, which in the absence of a treaty frequently will tax a branch operation even if the level of activity conducted in the country is negligible. Under these favorable treaty rules, U.S. manufacturers may establish a significant foreign presence through which products are sold without subjecting themselves to foreign tax. Similarly, U.S. residents generally may live and work abroad for short periods without becoming subject to the other country's taxing jurisdiction.

These rules are general guidelines that do not address every conceivable situation. Consequently, there will be cases in which double taxation occurs in spite of the treaty. In such cases, the treaty provides mechanisms enabling the tax authorities of the two governments -- known as the "competent authorities" in tax treaty parlance -- to consult and reach an agreement under which the

taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation.

In a world in which most major economic powers have extensive tax treaty networks, the absence of a U.S. tax treaty with a particular country can be a distinct disadvantage to U.S. businesses competing in that foreign market, and to the ability of the United States to attract foreign investments from that country. Securing a more level playing field for U.S. companies is particularly important given the substantial and increasing volume of cross-border investment by our major trading partners. In 1980 the level of U.S. direct investment abroad was about the same as that of the European Community and Japan together. However, by 1990, the level of direct investment abroad from the European Community and Japan had risen to about double that of the United States.

Prevention of Tax Evasion

All the aspects of tax treaties that I have been discussing involve benefits that the treaties provide to taxpayers, especially multinational companies, but also to individual citizens. While providing these benefits certainly is a major purpose of any tax treaty, it is not the only purpose. The second major objective of our income tax treaty program is to prevent tax evasion and abuse of the treaties. Tax treaties achieve this objective in at least two major ways. First, they provide for exchange of information between the tax authorities. Second, they contain provisions designed to ensure that residents of the treaty partner generally may enjoy the benefits of the treaty only if they have a substantial nexus with their country of residence.

Under the tax treaties, the competent authorities are authorized to exchange information, including otherwise confidential taxpayer information, as may be necessary for the proper administration of the countries' tax laws. This aspect of our tax treaty program is one of the most important features of a tax treaty from the standpoint of the United States. The information that is exchanged may be used for a variety of purposes. For instance, the information may be used to identify unreported income or to investigate a transfer pricing case. In recent years information exchange has become a priority for the United States in its tax treaty program.

To highlight the importance of this aspect of the tax treaty program, the Department of Justice has written a letter expressing its support for these treaties, a copy of which is appended to this testimony for the Committee's information.

A second major objective is to obtain comprehensive provisions designed to prevent abuse of the treaty by persons who are not bona fide residents of the treaty partner. This practice, which is

known as "treaty shopping," can take a number of forms, but its general characteristic is that a resident of a third state that has either no treaty with the United States or a relatively unfavorable one establishes an entity in a treaty partner that has a relatively favorable treaty with the United States. This entity is used to hold title to the person's U.S. investments, which could run the gamut from portfolio stock investments to a major operating company, or otherwise engage in treaty-favored activity in the United States. By placing the investment in the treaty partner, the person is able to withdraw the returns from the U.S. investment subject only to the favorable rates provided in the tax treaty, rather than the higher rates that would be imposed if the person had invested directly in the United States.

In the past this Committee has expressed strong concerns about treaty shopping, and the Treasury Department shares those concerns. If treaty shopping is allowed to occur, then there is less incentive for the third country with which the United States has no treaty to negotiate a treaty with the United States. With no treaty, the country maintains its barriers to U.S. investors. There may be good reasons why the United States has not concluded a treaty with a particular country. For instance, we generally do not conclude tax treaties with jurisdictions that do not impose significant taxes, because there is little danger of double taxation of income in such a case and it would be inappropriate to reduce U.S. taxation on inbound investment returns if the other country cannot offer a corresponding benefit in exchange for favorable U.S. treatment. If investors from such countries were able to enjoy the benefits of a treaty between the United States and another country, and at the same time enjoy the benefits of a tax haven regime in their home country, this policy would be undermined.

In recognition of these concerns, the Treasury Department has included in all its recent tax treaties comprehensive "limitation on benefits" provisions that limit the benefits of the treaty to bona fide residents of the treaty partner. These provisions are not uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners's internal laws and practices.

Transfer Pricing

Several of the aspects of income tax treaties that I have been describing are highly relevant to an issue that has been a contentious one in recent years and that is of very serious concern to the Administration. That issue is transfer pricing.

Transfer pricing relates to the division of the taxable income of a multinational enterprise among the jurisdictions where it does

business. If a multinational manipulates the prices charged in transactions between its affiliates in different countries, the income reported for tax purposes in one country may be artificially depressed, and the tax administration in that country will collect less tax from the enterprise than it should. Accordingly, transfer pricing is an important subject not only in this country but in most other industrialized countries as well.

In analyzing the prices charged in any transaction between affiliated parties, it is necessary to have a benchmark by which to evaluate the prices charged. The benchmark adopted by the United States and all our major trading partners is the arm's length standard. Under the arm's length standard, the price charged should be the same as it would have been had the parties to the transaction been unrelated to one another -- in other words, the same as if they had bargained at "arm's length."

One of the principal advantages of this approach is its neutrality: it does not ask the multinational to report a result different from that which would have been achieved by unrelated parties. This neutrality means that multinational enterprises are treated neither more nor less favorably than unrelated parties.

Consistent with the domestic practice of all major trading nations, all of our comprehensive income tax treaties adopt the arm's length standard as the agreed benchmark to be used in addressing a transfer pricing case. Adoption of a common approach to these cases is another benefit provided by tax treaties. A common approach guarantees the possibility of achieving a consistent allocation of income between the treaty partners. Without such an assurance, it is possible that the two tax authorities would determine inconsistent allocations of income to their respective jurisdictions, resulting in either double or under taxation. Double taxation would occur when part of the multinational's income is claimed by both jurisdictions. Under taxation would occur when part of the multinational's income is claimed by neither jurisdiction.

By adopting a common standard, the risks of double and under taxation are minimized. Furthermore, when double taxation does occur, the competent authorities of the two countries are empowered to consult and agree on an equitable division of income based upon this common reference point. Without this common reference point, reaching mutual agreement would be difficult.

One of the principal criticisms of the arm's length standard is that it requires judgements to be made about the price unrelated parties would have agreed to under similar circumstances. Generally this sort of judgment requires one to refer to transactions between unrelated parties. In some cases this information can be difficult to obtain. This difficulty has been cited in support of replacing or supplementing the arm's length

standard by an alternative approach similar to that employed by the states. Further, it has been suggested that these treaties should not be approved unless they permit a standardized formulary approach in addition to or in place of the arm's length standard.

Obviously, this hearing on seven income tax treaties and protocols is not the time or place to debate this issue. I will say, however, that the paramount consideration in selecting an approach for the analysis of transfer pricing issues is that there be broad international consensus in favor of its use and a commitment to administer the approach in a similar way. Without that consensus, widespread double and even under taxation will inevitably occur. Therefore, a unilateral move, or even an announcement that a country is considering a move to a different approach, can be expected to lead to more problems than it solves.

The United States and its trading partners have made a concerted effort in the last two years to address the shortcomings of the arm's length standard. We believe that these efforts will maintain the arm's length standard as a viable approach. However, if the United States and its partners decide one day that the arm's length standard should be abandoned in favor of some other approach, I can assure this Committee that our tax treaties will not stand in our way. In such a case, we will agree on a new approach and will develop guidelines for uniform application of that approach. The tax treaties would inevitably give way in the face of this new consensus.

Basis for Negotiations

Each of these treaties reflects current U.S. treaty policy, as developed jointly by the Treasury Department and the Congress in recent years. The provisions in each treaty borrow heavily from recent treaties approved by the Senate, particularly the treaties with the Czech Republic, Germany, Mexico, the Netherlands and Spain. Many aspects of these treaties in turn are derived from the 1992 OECD Model Income Tax Convention and its predecessor, the 1977 OECD Model. The United States is an active participant in the development of the OECD Model, and we are generally able to use most of its provisions as a basis for negotiations. This ability greatly facilitates the process, as most of our treaty partners also are relatively comfortable with the OECD Model.

These treaties are not based on a U.S. Model Income Tax Convention. The United States has published model treaties in the past, most recently in 1981. In 1992 that treaty was withdrawn because it did not reflect recent legislative and other policy changes in the United States and because certain of its provisions, most notably the limitation on benefits provision, were found deficient. Accordingly, in evaluating these treaties, it generally is not useful to make comparisons to the former U.S. model treaty,

as the former model did not serve as the basis for concluding the seven agreements you have been asked to consider.

The fact that the 1981 Model was withdrawn three years ago does not mean that we believe that there is no useful role for a U.S. model. It is true that most countries use the OECD Model, or a model treaty developed by the United Nations, as the basis for their negotiations. However, at least two aspects of United States tax policy make it desirable for this country to have its own model treaty. First, our legislation is uniquely complex. Any treaty must accommodate the provisions of our internal law to an extent not found in other countries. Examples include the treatment of foreign-owned real property, the branch profits tax, the treatment of real estate mortgage conduits, and taxation of U.S. citizens on their worldwide income regardless of their residence. Second, our treaty policy demands certain additional provisions not directly reflected in internal legislation. Our insistence that every U.S. tax treaty contain a comprehensive limitation on benefits provision is one example. Only a United States model income tax convention can fully accommodate these prerequisites. Therefore, we have been developing a new U.S. model treaty in recent months, and we intend to complete that project and publish a new model treaty as soon as time and resources permit.

A model treaty is not a panacea, however. Even after the U.S. publishes a new model treaty, no treaty will ever be an exact duplicate of a model, nor should it be. While any two treaties will usually have a number of provisions that are virtually identical, certain aspects of each treaty must be tailored to the individual facts and circumstances of the two treaty partners. Numerous features of the treaty partner's legislation and its interaction with U.S. legislation must be considered in negotiating an appropriate treaty. Examples include the treatment of partnerships and other transparent entities, whether the country eliminates double taxation through an exemption or credit system, whether the country has bank secrecy legislation that needs to be modified by treaty, and whether and to what extent the country imposes withholding taxes on outbound flows of investment income. Consequently, a negotiated treaty needs to take into account all of these and other aspects of the treaty partner's tax system in order to arrive at an acceptable treaty from the perspective of the United States. Accordingly, a simple side-by-side comparison of two actual treaties, or between a proposed treaty and a model treaty, will not enable one to draw meaningful conclusions as to whether a proposed treaty is appropriate and should be ratified. Finding the answer to that important question is a more complicated exercise, and one that the Treasury goes through before any treaty or protocol is signed.

Evaluation of Individual Treaties

In addition to keeping in mind that each treaty must be adapted to the individual facts and circumstances of each treaty partner, it also is important to remember that each treaty is the result of a negotiated bargain between two countries that often have conflicting objectives. Each country has certain issues that it considers non-negotiable. The United States, which insists on effective anti-abuse and exchange of information provisions, and which must accommodate its uniquely complex internal laws, probably has more non-negotiable issues than most countries. Obtaining the agreement of our treaty partners on these critical issues sometimes requires concessions on our part. Similarly, other countries sometimes must make concessions to obtain our agreement on issues that are critical to them. The give and take that is inherent in the negotiating process leading to a treaty is not unlike the process that results in legislation in this body. Therefore, no two treaties are exactly the same, and no treaty is entirely ideal from the point of view of either treaty partner.

An example of the result of the negotiation process is provided by the treatment of income from container leasing. For many years the Treasury Department's policy has been that container leasing income should be treated as shipping income taxable only in the country of residence of the recipient. The basis for this position is that container leasing is more like shipping income than royalty income or equipment leasing income. Therefore we try to include this treatment in all treaties. It also will be included in the new model treaty.

We often succeed in obtaining the desired treatment. However, as part of the give and take of the negotiating process we are sometimes not able to obtain full shipping income treatment. In such cases, we strive to obtain incidental shipping income treatment and business profits treatment for container leasing income not incidental to a shipping business. Business profits treatment gives the same result as shipping income treatment when the lessor does not have a permanent establishment in the source state. Developing countries, however, often treat container leasing income as royalty income subject to withholding at source. We have consistently objected to this treatment and will continue to do so. In some cases we have agreed to royalty treatment, but with a zero rate of withholding, which gives the same result as business profits treatment. It is our continuing policy and intention to include full shipping income treatment for container leasing income, with business profits treatment as the fall-back alternative. The treaties with all seven of the countries we are dealing with today reflect our success in achieving this objective.

In evaluating the benefits provided to taxpayers and the tax authorities by any treaty, it would be a mistake to focus solely on the provisions that differ from other treaties. It is important to

bear in mind that most of the provisions in any two treaties are very similar and in some cases identical. Perhaps because of their similarity, many of these provisions are routine and non-controversial, and they attract little attention. Their importance, however, should not be underestimated. These provisions are responsible for many of the benefits that a tax treaty provides to taxpayers and tax authorities. Therefore, when evaluating the overall benefits provided by an income tax treaty, it is important to consider not only the benefits of lowered withholding rates and other non-standard provisions, but also the benefits provided by these more standard provisions. Many of these rules provide taxpayers with more favorable treatment than otherwise would be available, as well as the benefits of certainty and transparency. Others improve the ability of the tax authorities to administer the tax laws.

For example, each proposed treaty establishes relatively uniform rules for taxing income other than investment income, including business profits, capital gains, and personal services. Social security benefits under each proposed treaty will be subject to tax in the country making the payment.

Each treaty reflects standard U.S. policy for the taxation of dividends paid by regulated investment companies (RICs) and real estate investment trusts (REITs). Special rules are provided to prevent the use of these entities to transform what should be relatively high-taxed income into income taxed at much lower rates. Each treaty allows the U.S. to impose the branch profits tax at the treaty's direct dividend rate. In addition, in conformity with what has become standard U.S. treaty policy, excess inclusions with respect to residual interests in real estate mortgage investment conduits are subject to the U.S. statutory withholding rate of 30 percent.

The proposed treaties also contain provisions designed to improve tax administration, including rules concerning exchange of information, mutual assistance, and nondiscrimination. They contain rules necessary for the administration of the treaty, including rules for the resolution of disputes and the exchange of information. Each treaty permits the General Accounting Office and the Tax Writing Committees of Congress to obtain access to certain tax information exchanged under treaty for use in their oversight of the administration of U.S. tax laws and treaties.

Each treaty also contains a comprehensive limitation on benefits provision designed to ensure that residents of each State may enjoy treaty benefits only if they have a substantial nexus with that State, or otherwise can establish a substantial non-treaty shopping motive for establishing themselves in their State of residence.

Finally, the treaties with France, Portugal and Sweden, and the protocol with Canada contain provisions not found in previous tax treaties in any country. These provisions reflect the Treasury Department's policy that tax discrimination disputes between two nations generally should be resolved within the ambit of the tax treaty, and not under any other dispute resolution mechanisms, including the World Trade Organization (WTO). The General Agreement on Trade in Services (GATS) already affords some protection, as it provides that national treatment disputes involving taxation measures will be resolved under tax treaties where the measure at issue falls within the scope of a tax treaty. With respect to treaties existing when the WTO entered into force (January 1, 1995), the GATS also provides that the parties to a tax treaty are not permitted to bring the issue of whether a measure is within the scope of a tax treaty to the Council for Trade in Services unless both parties to the tax treaty agree. For this rule to apply to tax treaties that enter into force after January 1, 1995, a specific provision must be included in the treaty. The provision we have included in these tax treaties sets forth this rule, providing that if there is a dispute as to whether a taxation measure falls under the tax treaty, such dispute will be resolved solely under the tax treaty in accordance with the dispute resolution mechanisms provided in the tax treaty. Further, no national treatment or most-favored nation obligation provided under another agreement will apply to a taxation measure (with the exception of the General Agreement on Tariffs and Trade as it applies to trade in goods). I hope that the Senate shares the Treasury's firm conviction that taxation disputes should be handled exclusively within the tax treaty and not in the World Trade Organization or elsewhere.

I would like to add that two of the treaties before you -- the treaties with Kazakhstan and Ukraine -- do not contain this provision. Although neither of these countries has acceded to the GATS, we believe that it would be appropriate to have similar provisions in the treaties so that a protocol or renegotiation would not be required later. The State Department therefore undertook to exchange diplomatic notes with the governments of these countries. We have completed an exchange of notes with Ukraine. These notes reflect the mutual understanding of the two governments that the treaty will be subject to the same restriction as the other agreements you are considering. We are continuing to work with the government of Kazakhstan and believe that similar notes will be exchanged shortly.

Finally, some treaties will have special provisions not found in other agreements. These provisions account for unique or unusual aspects of the treaty partner's internal laws or circumstances. For example, the Canadian Protocol contains provisions that deal with taxes at death, and the Portuguese treaty contains a special provision in the limitation on benefits article to deal with Portugal's offshore sector. Further, treaties with

countries that are not as economically advanced as some of our other treaty partners frequently contain different withholding and other provisions that reflect their transitional economic status. All of these features should be regarded as a strength rather than weakness of the tax treaty program, since it is these differences that enable each treaty to deal with the differing circumstances of the two treaty partners in a balanced way.

I now would like to discuss the most important aspects of each agreement that you have been asked to consider. We have submitted Technical Explanations of each agreement that contain detailed discussions of each treaty and protocol. These Technical Explanations serve as an official guide to each agreement, reflecting the policies behind each provision, as well as understandings reached between the negotiators regarding the application and interpretation of various provisions.

Canadian Protocol

The Protocol to the Canadian treaty would significantly change our taxation relationship with Canada. Since Canada is one of our most important economic partners, these proposed amendments have attracted considerable positive attention in the business communities of the United States and Canada. The amendments are also strongly supported by the tax administrations in both countries.

The negotiation of this Protocol initially was motivated by Canada's desire to alleviate the impact of 1988 U.S. estate tax legislation on estates of Canadian decedents with U.S. property. It quickly became clear that other changes should be made to accomplish several important objectives. The Protocol accordingly amends a number of provisions of the Convention to reflect better current tax law and treaty policy in both countries, to resolve certain technical problems that had been identified in the present Convention, and to achieve greater consistency with the principles underlying the North American Free Trade Agreement.

The Protocol was signed on March 17, 1995. It amends the existing Convention with Canada, which was signed in 1980 and amended by Protocols in 1983 and 1984. A very similar Protocol was signed in August, 1994 and submitted to the Senate. We subsequently realized that a few minor technical changes were appropriate. Most of these technical changes relate to the rules on death taxation. This Protocol incorporates these changes, and replaces the 1994 Protocol, which has been formally withdrawn from Senate consideration.

The Protocol reduces the rates of withholding at source on dividend, interest and royalty income in a manner that will have a significant positive impact on cross-border flows of capital and technology between the United States and Canada.

The direct investment dividend rate will be reduced over a three year phase-in period from 10 to 5 percent, which is the lowest rate in any current U.S. or Canadian treaty. This reduction will affect very large amounts of dividends flowing from subsidiaries in one country to parent corporations in the other, and will make cross-border investment more attractive.

The Protocol also reduces the rate of withholding on cross-border flows of interest from 15 to 10 percent. Although higher than the preferred U.S. position of exemption at source, this reduction will provide a substantial benefit to many U.S. recipients of Canadian-source interest payments. It will have a lesser effect on U.S. outflows of interest to Canada, because much of this flow is already exempt from U.S. tax under the portfolio interest provisions of the Code.

The Protocol also significantly reduces withholding taxes on royalties. While Canada has been willing to exempt royalties for copyrights of most literary and artistic works, it previously had opposed lowering the rate below 10 percent for software or other royalties. However, in an effort to encourage transfers of technology between the United States and Canada, Canada agreed in this Protocol to confirm that software royalties are exempt at source and to broaden significantly the categories of royalties subject to exemption at source to include royalties paid in respect of patents, as well as royalties paid in respect of information concerning industrial, commercial, or scientific experience ("know-how"). Canada has agreed to a similar provision with only one other country; that other provision applies only to transactions between unrelated persons and is, therefore, significantly more limited than the provision in the Protocol.

The United States held strongly to the view throughout the negotiations that the nature of U.S.-Canadian economic relations demands the lowest possible withholding rates. We negotiated this Protocol from the same policy perspective that led to the NAFTA; a desire for open economic borders. Although Canada was not prepared to reduce withholding rates as much as the United States would have liked, we agreed to discuss further reductions in withholding rates within three years of the entry into force of this Protocol. Canada's agreement to the substantial reductions provided by the Protocol, coupled with the commitment to hold further discussions in the near future, represents a significant positive step.

The Protocol does not change the existing Convention's treatment of income from container leasing as taxable only in the state of residence of the recipient.

As I indicated, two aspects of our tax treaty program that have a center-stage position are cooperation in tax compliance and the prevention of abuse of the treaty. This Protocol contains four sets of provisions that significantly advance these objectives.

First, the Protocol adds a comprehensive limitation on benefits article. The present treaty has no general anti-treaty-shopping rules. The limitation on benefits rules are unilateral, at Canada's request. Thus, they apply only to limit benefits that the U.S. otherwise must grant with respect to U.S. source income of Canadian residents. The inclusion of specific treaty shopping rules does not limit either State's right to invoke applicable anti-abuse principles to deny benefits where necessary to prevent abuse of the treaty. Although both the United States and Canada believe that such principles are inherently applicable under all their treaties, we agreed to include an explicit statement to that effect to preclude any argument that the unilateral nature of the anti-treaty-shopping provisions might prevent Canada from applying such principles. The statement is drafted reciprocally to clarify that the United States may apply such principles as well.

Second, the Protocol will broaden the information exchange provisions to include all national taxes. With respect to Canadian taxes, the present treaty covers only taxes imposed under the Income Tax Act, and any national taxes on estates and gifts.

Third, the Protocol adds detailed rules under which each State will, within appropriate limits, assist the other in the collection of its taxes. We have collection assistance provisions in several other income tax treaties, including our recent treaty with the Netherlands (and both the current and pending treaties with France and Sweden), and in many of our estate tax treaties. Because of the close working relationship between U.S. and Canadian tax authorities and the similarity of U.S. and Canadian law, we believe that Canada is an appropriate partner for collection assistance.

The collection assistance provisions fully protect taxpayer rights. For example, collection assistance may be requested only for finally determined claims. If at any point in the process the claim loses that status, the request must be withdrawn promptly. In addition, no assistance is to be provided in respect of an individual who was a citizen of, or an entity that was a resident of, the requested State at the time to which the claim relates.

Fourth, the Protocol will strengthen the dispute resolution mechanisms by amending an aspect of the present Convention that created potential for abuse. Unlike most treaties, the present Convention provides that the State making a transfer pricing adjustment must withdraw it, to the extent necessary to avoid double taxation, if the adjustment has not been reported to the other State within six years of the end of the taxable year to which it relates. This requirement could permit a taxpayer to force withdrawal of the initial adjustment by delaying cooperation with the tax authorities. To eliminate this potential for abuse, the Protocol removes the obligation of a State to withdraw its adjustment in such circumstances.

The Protocol also provides that the States may, by mutual agreement, implement an arbitration procedure for the resolution of disputes under the Convention. However, consistent with this Committee's 1990 report on the U.S.-Germany income tax treaty, and with the similar provisions of the income tax treaties with the Netherlands and Mexico approved by this Committee in 1993, the arbitration procedure provided for in this Protocol will not take effect automatically. As in the case of the Netherlands and Mexico treaties, the arbitration procedure can be put into effect only through an exchange of notes between the U.S. and Canadian Governments, after we have had experience that such a provision can operate effectively and efficiently. The Protocol provides that the appropriate authorities of the United States and Canada will consult, after three years, on whether and when it would be appropriate to bring the provision into effect.

Another important aspect of this Protocol is that it addresses taxes imposed by reason of death. Canada has replaced its estate tax regime with an income tax on gains accrued and deemed realized by the decedent at death. Since the U.S. tax at death is an estate tax, the two systems could not, absent special treaty rules, be coordinated in a way that would allow relief from double taxation. In the absence of treaty relief, the combined U.S. and Canadian taxes at death can exceed 75 percent. The death tax provisions of the Protocol are an important example of how treaties can be used to surmount technical differences between the tax laws of the two countries and provide appropriate relief from double taxation to ordinary citizens as well as multinational corporations. Prior to and during the negotiation of these provisions, we took advantage of the opportunity to discuss the policy and technical issues involved with the staffs of this Committee, the tax-writing committees, and the Joint Committee on Taxation. The value of these discussions is manifested in the successful results of our negotiations, which reflect such discussions.

Finally, the Protocol will broaden the scope of the non-discrimination article to include all national-level taxes in both States. Under the present treaty, Canadian coverage is limited to taxes imposed under the Income Tax Act. Thus, for example, the Canadian Goods and Services Tax would be added to the taxes in respect of which Canada would be obligated to provide non-discrimination protection.

The Protocol will enter into force upon the exchange of instruments of ratification. For withholding taxes on dividends, interest and royalties, it will have effect for amounts paid or credited on or after the first day of the second month of the year following its entry into force. For other taxes, the Protocol will have effect on the first day of the year following its entry into force. The reduction to 5 percent in the withholding rate on direct investment dividends will be phased in over a three year period. The rate will be reduced to 7 percent in 1995, 6 percent

in 1996, and 5 percent beginning in 1997. The branch tax rate will be reduced to 6 percent in 1996 and 5 percent thereafter.

French Treaty

The proposed treaty with France would replace the existing treaty signed in 1967 and amended by protocols signed in 1970, 1978, 1984, and 1988. The treaty follows the existing one in most respects but is updated to reflect current tax laws and tax treaty policies of the two countries. It clarifies some important issues affecting United States investors and business operations in France, and it introduces a modern limitation on benefits provision.

The treaty would maintain the existing treaty's rates of tax on direct and portfolio dividends, which are 5 and 15 percent, respectively. For certain portfolio dividends paid by a French company to a U.S. shareholder, France will allow a tax credit for all or a portion of the French corporate tax paid on distributed profits, which effectively eliminates the French dividend withholding tax. This is a significant benefit to U.S. investors, including pension funds and other tax-exempt organizations that invest in France.

The treaty maintains the existing treaty's exemption at source for interest.

Under the treaty, income from container leasing is treated as shipping income if the income is incidental to income from the operation of ships and aircraft in international traffic. Other income from container leasing is treated as business profits. Consequently, such income is taxable at source only to the extent that it is attributable to a permanent establishment located in the source country.

The treaty also maintains the existing treaty's exemption at source for copyright royalties and a tax of not more than 5 percent on other royalties. The proposed treaty clarifies the scope of the tax exemption for copyright royalties, which includes royalties paid to producers and performers (as well as creators), and royalties for software programs. This provision makes the rules clear not only for future years, but also for copyright royalties paid from 1991 to the present, representing a further significant benefit to U.S. investors.

Like all recent U.S. treaties, the French treaty incorporates a comprehensive limitation on benefits provision. The provision is broadly similar to the corresponding provision in the Netherlands treaty that was ratified in 1993, although the French version is substantially less detailed.

Like the Canadian Protocol, the Protocol to the proposed treaty also provides that the States may, by future exchange of notes, implement an arbitration procedure for dispute resolution.

Finally, the proposed treaty covers the U.S. excise tax imposed on insurance premiums paid to foreign insurers. In accordance with the prior direction of this Committee, this provision was included in the proposed treaty only after prior consultation with the appropriate Committees of Congress, and only after the Treasury Department was satisfied that the French taxation of French insurance companies results in a burden that is substantial in relation to the U.S. taxation of U.S. insurance companies.

The treaty will enter into force when both governments have completed their respective constitutional and statutory procedures and have exchanged instruments of ratification. The provisions with respect to withholding taxes on dividends, interest and royalties and the U.S. excise tax on French insurers and reinsurers generally will take effect for amounts paid or credited on or after the first day of the second month following entry into force of the treaty. The provisions relating to the French dividend tax credit will apply to dividends paid on or after January 1, 1991. The provisions for royalties will also apply for royalties paid on or after January 1, 1991. The other provisions of the treaty will take effect for taxable periods beginning, or taxable events occurring, on or after January 1 of the year following the entry into force.

Portuguese Treaty

The proposed treaty between the United States and Portugal is the first tax treaty between our countries. The treaty is based on the OECD model income tax treaty and is similar in many respects to the U.S. income tax treaty with Spain. It closes an important gap in the United States tax treaty network and is expected to provide a strong boost to our economic relations with Portugal. The treaty represents something of a hybrid between a treaty with a developing country and a treaty with a highly developed country, which is consistent with the fact that Portugal, while a member of the European Union, is relatively less developed by the standards of that organization. For example, Portugal's 1993 per capita gross domestic product of $8,700 is less than half of France's $18,200.

With respect to investment income, the treaty would lower withholding taxes on cross-border payments of dividends, interest, and royalties. The tax on dividends is gradually lowered from statutory rates to roughly follow Portugal's gradual adoption of European Union norms with respect to withholding taxes on dividends. Initially the tax on both portfolio and direct dividends would be limited to 15 percent. In 1997 the rate on direct dividends would be lowered to 10 percent, and the rate will

decline to 5 percent when Portugal fully adopts the European Union directive with respect to such dividends.

An unusual feature of this treaty is that it allows Portugal to continue to impose its 5 percent "substitute inheritance tax" on most dividends. Portugal imposes this tax on its own residents as well as on nonresidents, has never agreed to waive it in any treaty, and would not change its policy in this case. It views the tax as being more in the nature of an estate tax than an income tax and, therefore, not properly the subject of an income tax treaty. Portugal did, however, agree for the first time effectively to cap the tax at the current rate. This concession, together with Portugal's agreement to reduce the withholding tax on direct dividends to 5 percent, will put U.S. companies in a favorable position to compete in the Portuguese market.

The rate of tax on interest and royalties is generally reduced to 10 percent. Interest paid by or to the Government of one of the States or to a wholly-owned government institution is exempt from tax, as is interest paid on a long-term loan (5 years or more) made by a bank. These rates are significantly lower than the rates Portugal now applies to U.S. investors.

Income from container leasing is treated as royalty income, although a zero rate of withholding tax is provided in a protocol to the treaty, which effectively means that such income is subject to the same treatment as business profits. However, treatment of income from container leasing as royalty income is unusual, and the Treasury Department does not view it as a precedent for U.S. policy in future treaty negotiations.

As in all other recent U.S. income tax treaties, treaty benefits will be available only to residents of the two countries who satisfy certain requirements. The Portuguese treaty also contains a provision specifically directed at Portugal's offshore sector. Under this provision a person who would otherwise satisfy the requirements of the limitation on benefits provision will not be allowed treaty benefits if it is entitled to tax benefits that apply to tax-free zones in Madeira and the Azores.

The proposed treaty will enter into force on the date the instruments of ratification are exchanged, and its provisions will generally have effect on the following January 1.

Swedish Treaty

The proposed treaty with Sweden replaces the present income tax treaty between the two countries. The present treaty is the oldest tax treaty in force for both countries; it was signed in 1939, and was amended by a protocol signed in 1963. Considering the fact that it is more than half a century old, the present treaty deals remarkably well with the basic issues of the taxation

of cross-border flows of income and cooperation between the tax authorities of the two countries. It does not, however, deal with certain taxes, such as the branch profits tax, that were not in effect at the time the present treaty was negotiated, or with certain issues, such as treaty shopping, that were not of concern at that time.

The proposed treaty limits withholding tax rates at source on payments of dividends, interest and royalties. The treaty provides that the tax in the source country on dividends paid to a resident of the other country may not exceed 15 percent in the case of portfolio dividends and 5 percent in the case of direct investment dividends. The treaty provides for exemption at source for interest and royalties. These are the same rates that are provided for in the present treaty.

The proposed treaty treats income from container leasing as shipping income taxable only in the state of residence of the recipient.

The proposed treaty limits the applicability of the Swedish capital tax with respect to certain U.S. citizens and residents who are not Swedish residents, or who are only temporarily resident in Sweden. The treaty also exempts the Swedish Nobel Foundation from U.S. tax on its U.S.-source investment income. The proposed treaty also retains the provision on assistance in collection contained in our present treaty with Sweden.

Like the proposed treaty with France, the proposed treaty covers the U.S. excise tax imposed on insurance premiums paid to foreign insurers. As in the case of the French provision, this provision was included in the proposed treaty only after prior consultation with the appropriate Committees of Congress, and only after the Treasury Department was satisfied that the Swedish taxation of Swedish insurance companies results in a burden that is substantial in relation to the U.S. taxation of U.S. insurance companies.

The proposed Convention is subject to ratification and enters into force on the exchange of instruments of ratification. With respect to the United States taxes payable at source, it will have effect for amounts paid or credited on or after the first day of January following entry into force, and in the case of other U.S. taxes, for taxable year beginning on or after that date. The treaty will have effect with respect to Swedish income taxes for any income derived on or after the first day of January following entry into force, and with respect to Swedish capital taxes for any taxes that are assessed in or after the second calendar year following entry into force (i.e., 1997 if the treaty enters into force in 1995).

Kazakhstan Treaty

The proposed treaty with Kazakhstan would replace, with respect to Kazakhstan, the treaty entered into between the United States and the former Union of Soviet Socialist Republics in 1973. The proposed treaty is based on the OECD model income tax treaty and on the current tax laws and income tax treaty policies of the two countries. It is an important step in furthering the U.S. policy of supporting the expansion of free enterprise in the newly independent states.

The proposed treaty would limit withholding tax at source on dividends, interest and royalties. The rate on portfolio dividends would be 15 percent and the rate on direct investment dividends would be 5 percent. The direct investment rate of 5 percent would also apply for purposes of imposing the branch profits tax on the dividend equivalent amount. The rate of tax on interest would generally be 10 percent. The tax would be reduced to zero, however, if the interest were paid by or to the government of the United States or Kazakhstan, or if the interest were paid on a loan of more than three years made, guaranteed or insured by an export credit agency (including the Export Import Bank or the Overseas Private Investment Corporation). The rate on royalties would generally be 10 percent.

Under the treaty, income from container leasing is treated as shipping income taxable only in the state of residence of the recipient.

The treaty confirms that wage and interest expenses are deductible for purposes of determining the Kazakhstan income tax liability of U.S.-owned enterprises, helping to ensure that the Kazakhstan income tax will be creditable for U.S. tax purposes.

Like the Canadian Protocol and the French treaty, the Protocol to the proposed treaty also provides that the States may, by future exchange of notes, implement an arbitration procedure for dispute resolution.

The treaty will generally take effect on January 1 of the year in which the two countries exchange instruments of ratification. With respect to taxes withheld at source (on dividends, interest, and royalties), the treaty will apply to amounts paid or credited on or after the first day of the second month following the exchange of instruments.

Ukrainian Treaty

The proposed treaty with Ukraine replaces, with respect to Ukraine, the 1973 income tax treaty between the United States and the former Union of Soviet Socialist Republics. The proposed treaty is based on the OECD model income tax treaty and the current

income tax laws and income tax treaty policies between the two countries. Like the proposed treaty with Kazakhstan, it confirms U.S. support for strengthening free enterprise and market forces in these newly independent countries.

With respect to investment income, the proposed treaty would limit the withholding tax at source on dividends, interest, and royalties. The rate on portfolio dividends would be 15 percent, the rate on direct investment dividends would be 5 percent, and the rate on royalties would be 10 percent. Interest would be exempt from tax in the source country. The direct investment rate of 5 percent would also apply for purposes of imposing the branch profits tax on the dividend equivalent amount.

Under the treaty, income from container leasing is treated as shipping income taxable only in the state of residence of the recipient.

The proposed treaty with Ukraine would deem a permanent establishment to exist with respect to a construction site or installation or drilling rig if the site lasts more than 6 months.

The Protocol to the treaty confirms that wages and interest expenses will be deductible for purposes of determining the Ukrainian income tax liability of U.S.-owned enterprises, helping to ensure that the Ukrainian income tax will be creditable for U.S. tax purposes.

The treaty will enter into force on the date instruments of ratification are exchanged. However, if the provisions of the 1973 convention are more beneficial, then a taxpayer may elect to apply that convention in full for an additional period (generally one taxable year) after the proposed treaty would otherwise take effect.

Conclusion

Let me conclude by urging the Committee to take prompt and favorable action on all of the Conventions and Protocols before you today. Such action will send an important message to our trading partners and our business community. It will demonstrate our desire to expand the U.S. treaty network with income tax treaties formulated to enhance the worldwide competitiveness of U.S. companies. It will strengthen and expand our economic relations with countries that have seen significant economic and political changes in recent years. It will make clear our intention to deal bilaterally in a forceful and realistic way with treaty abuse. Finally, it will improve the ability of the Internal Revenue Service to enforce our tax laws and to resolve difficult issues that arise in international transactions.

U. S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General | Washington, D.C. 20530

January 20, 1995

Honorable Jesse Helms
Chairman
Committee on Foreign Relations
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Seven income tax treaties (or protocols) are pending before the Foreign Relations Committee, including treaties or protocols with Canada, France, Kazakhstan, Mexico, Portugal, Sweden and the Ukraine. The Department of Justice would like to take this opportunity to urge that the Committee and the Senate approve these agreements at the earliest date practicable.

The civil and criminal enforcement actions of the Tax Division of the Justice Department are increasingly dependent on our ability to obtain foreign evidence (usually in the form of bank records) or foreign assets. Therefore, it is especially helpful to us that the treaties forwarded by the President have exchange of information provisions that will improve the ability of federal investigators and litigators to obtain evidence, including bank records and witness testimony, for civil and criminal tax matters. These provisions will also improve the ability of federal authorities to obtain evidence in a form admissible for U.S. court proceedings.

Further, three of these pacts (the proposed protocol with Canada and the proposed updated treaties with France and Sweden) contain a particularly useful provision for mutual collection assistance (MCA) already found in several existing tax conventions including the recently ratified Netherlands Convention.

Under the Canadian provision, for example, federal tax authorities would be permitted to reach assets in Canada under the same circumstances in which collection can be undertaken for assets located in the United States following proper assessment

procedures. This provision contains features aimed at bringing international tax collection assistance up to the efficiency levels of domestic tax collections, while, at the same time, preserving all the rights due taxpayers and property owners under the domestic laws of the respective countries. This provision does not obligate the United States to collect Canadian taxes owed by U.S. citizens or corporations.

The Department believes that all seven pacts will greatly enhance the tax enforcement capabilities of the United States government and lead to a significant increase in the collection of unpaid taxes properly due the public treasury.

The Office of Management and Budget has advised that there is no objection to the submission of this report from the standpoint of the Administration's program.

Sincerely,

Sheila F. Anthony
Assistant Attorney General

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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FOR RELEASE UPON DELIVERY
Expected at 10:00 a.m. EDT
June 13, 1995

STATEMENT OF
JOSEPH H. GUTTENTAG
INTERNATIONAL TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

Mr. Chairman and members of the Committee, my testimony will cover a proposed Protocol to the Income Tax Convention with Mexico.

The proposed protocol with Mexico would make two changes to the exchange of information provisions of the income tax treaty approved by the Senate in 1993.

These provisions are related to one of the major purposes of any income tax convention: the prevention of tax evasion. A principal means of preventing tax evasion is the exchange of tax information. Tax information exchanged under an income tax convention may be used only for tax purposes and may be disclosed only to persons involved in tax assessment, collection, administration, enforcement or prosecution. Under the current Mexican tax treaty, information is exchanged solely to carry out the provisions of tax laws imposed at the level of the national or federal government.

The first change is a purely technical change. The treaty currently incorporates the obligations to exchange tax information provided under the tax information exchange agreement ("TIEA") of November 9, 1989. The proposed protocol would incorporate into the tax treaty the obligations to exchange tax information provided under any TIEA between the United States and Mexico. The TIEA of November 9, 1989, has been amended to apply tax information exchange to taxes imposed at the state and local levels and to update certain statutory references.[1]

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[1] The amendments to the TIEA are not before the Committee because the TIEA is an agreement with specific statutory authorization (under section 927(e)(3) and section 274(h)(6)(C)).

RR-367

Second, the proposed protocol would apply the exchange of information provisions of the treaty to taxes imposed at the state and local levels.

The effect of the two changes will be to permit the U.S. competent authority to share the tax information it receives from the Mexican competent authority with state or local tax authorities where the information is relevant to the enforcement of a state or local tax. In addition, the U.S. competent authority will be permitted to ask the Mexican competent authority for specific information in connection with state or local tax compliance efforts.

The protocol is consistent with our treaty policy and is responsive to concerns raised by Arizona, California, New Mexico and Texas. These states created the Border States Caucus, which sought the benefits of tax information sharing with Mexico -- not only to increase compliance with state and local tax laws, but also to enhance cross-border trade.

Cooperation in this area has the potential to help business on both sides of the border. For example, the border states will be able to reduce and simplify the requirements for exempting Mexican merchants from state sales taxes on goods purchased in the U.S. for export into Mexico. Mexico will be able to adopt a mechanism that reduces the administrative costs borne by U.S. merchants in the refund process of Mexico's value-added tax.

I have attached to my testimony a copy of a letter from Ernest J. Dronenburg, Jr., Vice-Chair of the State of California Board of Equalization, and Chairman of the Border States Caucus, describing the importance of this protocol to the Border States Caucus.

The protocol will enter into force when the Contracting States have notified each other that their respective statutory and legal requirements for entry into force have been satisfied.

I urge the Committee to approve this agreement, which will greatly assist the states bordering on Mexico in the administration of their tax laws.

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ERNEST J. DRONENBURG, JR.
MEMBER, STATE BOARD OF EQUALIZATION

September 2, 1994

Mrs. Cynthia G. Beerbower
Deputy Assistant Secretary
U.S. Dept. of Treasury, Tax Dept.
1500 Pennsylvania Avenue
N.W. Washington, D.C. 20220

FAX COPY- Signed original in today's mail

Dear Ms. Beerbower:

Re: Amending the U.S./Mexico Tax Treaty: Benefits of the Inclusion of State Taxes in the Information Exchange Provisions

Consideration should be given to amending the U.S./Mexico Tax Treaty and TIEA to broaden the exchange of tax information between Mexico and the United States to include state and local taxes. This recommendation was generated by the Border States Caucus (BSC), an association representing the states of California, Arizona, New Mexico, Texas, and the United Mexican States formed in May of 1993 to promote free trade and reduce adminsitrative barriers to trade. The BSC is convinced that the benefits of information exchange will inure to all four member states.

Although there has been considerable commerce along the U.S. border for a number of years, the passage of the North American Free Trade Agreement (NAFTA) this year, it is obvious to all that the flow of commerce across the California/Mexico border will increase significantly in both directions. However, there are key dates and activities that have occurred already and dates in the future which will have a significant impact on this issue. Among these mile posts of increased international activity are:

1. Congress passed the Intermodal Surface Transportation Efficiency Act (ISTEA) which became

effective December 18, 1991 (Section 408 Public Law 102-240). This act mandates that all states shall become members of the International Fuel Tax Agreement (IFTA) by October 1, 1996. Twenty-nine states, including Arizona and three Canadian provinces, are now members of IFTA. New Mexico will become an active member on January 1, 1995, Texas on July 1, 1995, and California on January 1, 1996. Mexico and its states have not decided if they will participate in IFTA.

2. On May 13, 1993, in Phoenix, Arizona, the Border States Caucus was formed. The caucus is made up of the head tax administrators of Arizona, California, New Mexico, Texas, and the United States of Mexico. The caucus has since met quarterly with the goal of improving tax compliance between each other and increase commerce between all by reducing tax administrative barriers. (Mission statement attached)

3. Due to the passage of NAFTA in November, 1993, Mexican charter tour buses have had the opportunity to access the border states since January 1, 1994.

4. Per NAFTA, by December, 1995, trucks from California will be permitted to make cross border deliveries and pickups of cargo in the Mexican border states. Mexican trucks will be permitted into the U. S. border states for the same purposes. Additionally, trucks will be allowed to pick up and move cargo within border states, i.e., Mexican trucks will be able to move cargo from California to Arizona and California trucks will be able to move cargo from Sonora to Baja California.

With the inclusion of state taxes in the information exchange provisions of the U. S./Mexico Tax Treaty, the border states and Mexico will be able to design tax administration systems that will reduce the amount of paperwork and more resemble the importance of the substances of the transactions. At the same time, they will be able to

establish new procedures eliminating cash flow obstacles that currently exist in international commerce. Additionally, more comprehensive tax compliance programs will develop which target the underground economies on both sides of the border.

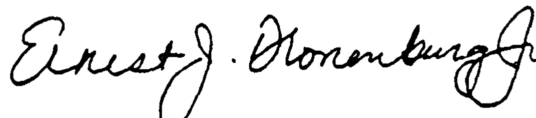
As an example of the increase in commerce, let me discuss a future (after states are allowed to exchange information) resale transaction between a California retailer and a Mexican wholesaler. The California retailer will call the Mexican wholesaler, discuss a purchase, a price will be struck, then the California retailer will give the Mexican wholesaler his California resale permit number. The Mexican wholesaler will then zero rate the transaction (zero rate meaning no VAT charged). This transaction will allow the California retailer to purchase more in Mexico since he will not have to be billed the VAT and then apply for, and hopefully receive, a credit or cash for the VAT paid. This new system also adds certainty to the transaction, i.e., no VAT will be charged, no loss of money because of a change in the currency exchange rate, and no concern whether the Mexican wholesaler will remain in business, change locations, or lose paperwork. After December, 1995, the California retailer will be able to have his own truck driven across the border to pick up the goods leaving the resale certificate with the Mexican wholesaler.

As an example of the increased compliance benefits from the amendment of the treaty, let me discuss a concern of both California and Mexico. Because both have tax systems in which auditors rely on sales markups for verification of total sales reported, that is, where purchases are marked up by computed shelf prices to determine expected retail sales, it is crucial that a provable purchase number be determinable. Requests for information about purchases made by California retailers in Mexico and Mexican retailers in California will be used by both sides to verify the completeness of recorded purchases of both retailers. The best way the underground economy has of evading the sales tax or VAT is to not record purchases, which results in unreported sales and unreported income. The State of California routinely audits corporations and in major cases, has been successful in prosecuting people based on evidence of purchases marked up to expected sales.

The above examples are the products of discussions and plans of the Border States Caucus. They are supported by all members and the details for operational requirements are now being worked out. The Border States Caucus has also completed a draft Exchange of Information Agreement, and each state is drafting the needed statutes to support it.

In conclusion, in order for a resale system to be put in place in Mexico (a system that currently doesn't exist), Mexico must have access to the information from California about which companies are in what fields of business. As stated above, it is crucial to California and Mexico tax audit purposes that all purchases from all sources be known. Another example of a need for tax information is the fuel tax information that Mexican truckers will need from California to be in compliance with IFTA and, conversely, so too will California truckers. In the future, under NAFTA, with reduced or eliminated duties and an open border, there will be an increase in tax evasion opportunities in other areas, such as Cigarette and Alcoholic Beverage tax programs. To stop this future evasion, the states will need a fast network of information exchange with Mexico.

Most cordially,



Ernest J. Dronenburg, Jr.
Member, State Board of Equalization
Chairman, Border States Caucus

EJD/ed
Enclosure
cc: Fred Dulas

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TREASURY DEPARTMENT
TECHNICAL EXPLANATION OF THE ADDITIONAL PROTOCOL
SIGNED AT MEXICO CITY, ON SEPTEMBER 8, 1994 AND
MODIFYING THE CONVENTION 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, D.C., ON SEPTEMBER 18, 1992

INTRODUCTION

This is a technical explanation of the Additional Protocol, signed at Mexico City on September 8, 1994 ("the Protocol") that Modifies the Convention between the United States of America and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on September 18, 1992 ("the Convention").

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

Article I

Article 1 of the proposed Protocol replaces the text of Article 27 (Exchange of Information) of the Convention. Under the new text of paragraph 1 of Article 27, the Competent Authorities are authorized to exchange information with respect to any tax covered by, and in accordance with, the provisions of any agreement between the Contracting States for the exchange of information with respect to taxes. The prior text referred to a particular agreement -- the Agreement Between the United States of America and the United Mexican States for the Exchange of Information with Respect to Taxes signed on November 9, 1989 ("the TIEA"). The effect of the new text is to broaden the reference, authorizing information exchange under the TIEA, under a revised version of the existing agreement, or under any new agreement or agreements.

The broadening of the authorization under paragraph 1 of Article 27 will have an immediate effect as follows. Under a protocol to the TIEA, which is attached as Appendix I, information exchange under the TIEA will apply to taxes imposed by a state, municipality, or other political subdivision or local authority of a Contracting State. However, this agreement shall not apply to taxes imposed by a possession of a Contracting State. This change to the TIEA will mean that information exchange with Mexico can be used to administer and enforce these sub-federal taxes. The Treasury Technical Explanation to the

TIEA protocol is attached as Appendix II.

Under the new text of paragraph 2 of Article 27, information will be exchanged under the provisions of that paragraph in the event there is no agreement in effect between the Contracting States for the exchange of information with respect to taxes. Thus, if the TIEA is terminated and replaced by another information exchange agreement, information will be exchanged under the provisions of that other agreement rather than under the provisions of paragraph 2.

Under the new text of paragraph 3 of Article 27, information exchange under Article 27 will apply to all taxes imposed by a Contracting State, including taxes imposed by a state, municipality, or other political subdivision or local authority thereof. As the possessions are not covered by the Convention, this change will not involve taxes imposed by possessions. Under the prior text of paragraph 3, information exchange was limited to all federal taxes.

The proposed Protocol does not contain a provision concerning the relationship of the Convention to other international agreements, including the General Agreement on Trade in Services (GATS). Such a provision is not necessary.

Article XXII(3) of GATS provides that a Member of the World Trade Organization may not invoke the obligation of national treatment under Article XVII of GATS with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In the case of a dispute between Members as to whether a measure falls within the scope of such an agreement between them, Article XXII(3), footnote 11, of GATS provides that, with respect to agreements on the avoidance of double taxation which exist on the date of entry into force of the WTO Agreement, the dispute may be brought before the Council for Trade in Services only with the consent of both parties to the agreement on double taxation.

Both Parties agree that a protocol to a convention that is grandfathered under Article XXII(3), footnote 11, of the GATS is also grandfathered. Further, without regard to the grandfather provision, it is clear under the GATS and its interpretative documents that neither national treatment nor most-favored-nation obligations of GATS extend to mutual administrative or judicial assistance.

ARTICLE II

Article II provides the requirements for entry into force of the proposed Protocol, which are that the Contracting States will notify each other when their respective statutory and legal

requirements for the entry into force of this protocol have been satisfied. The protocol will enter into force when the later of the two notifications is received.

ARTICLE III

Article III provides that the proposed Protocol shall remain in force as long as the Convention and Protocol of September 18, 1992, remain in force.

PROTOCOL THAT MODIFIES THE AGREEMENT BETWEEN THE UNITED STATES OF AMERICA AND THE UNITED MEXICAN STATES FOR THE EXCHANGE OF INFORMATION WITH RESPECT TO TAXES, SIGNED AT WASHINGTON, D.C., ON NOVEMBER 9, 1989

The United States of America and the United Mexican States, desiring to amend the Agreement for the Exchange of Information with Respect to Taxes, signed on November 9, 1989, have agreed as follows:

1. To amend paragraph 4 of Article 2 (Taxes Covered) to read as follows:

"4. This Agreement shall also apply to taxes imposed by a state, municipality, or other political subdivision or local authority of a Contracting State. However, this agreement shall not apply to taxes imposed by a possession of a Contracting State."

2. To amend paragraph 4 b) of Article 4 (Exchange of Information) to read as follows:

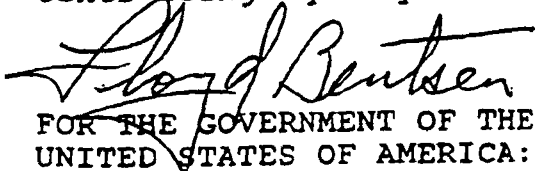
"b) If the United States is requested to obtain the types of information covered by section 3402 of the Right of Financial Privacy Act of 1978 (12 USCA 3402) as in effect at the time of signing this agreement, it shall obtain the requested information pursuant to that provision or any other similar or equivalent provision that may be added to or substituted for the above-mentioned provision. If Mexico is requested to obtain the types of information covered by Article 117 of the

Credit Institutions Law as in effect at the time of signing this Agreement, it shall obtain the requested information pursuant to that provision or any other similar or equivalent provision that may be added to or substituted for the above-mentioned provision. Laws or practices of the requested State do not prevent or otherwise affect the authority of the competent authority of the requested State to obtain and provide the types of information covered by the above-cited provisions pursuant to the Agreement."

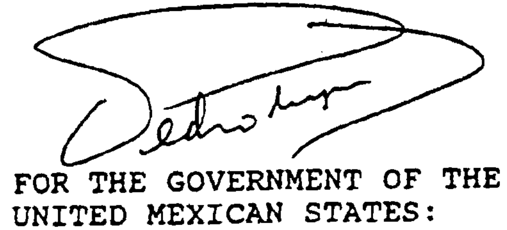
This Protocol shall enter into force upon an exchange of notes by the duly authorized representatives of the Contracting States confirming their mutual agreement that both sides have met all constitutional and statutory requirements necessary to effectuate this Protocol. This Protocol shall remain in force as long as the Agreement being amended remains in force.

IN WITNESS WHEREOF, the undersigned, being duly authorized thereto by their respective Governments, have signed this Protocol.

DONE at Mexico City, on the day of , 1994, in duplicate, in the English and Spanish languages, both texts being equally authentic.



FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:



FOR THE GOVERNMENT OF THE UNITED MEXICAN STATES:

APPENDIX II

May 16, 1995

TREASURY DEPARTMENT
TECHNICAL EXPLANATION OF THE PROTOCOL
SIGNED AT MEXICO CITY ON SEPTEMBER 8, 1994
AMENDING THE AGREEMENT BETWEEN THE UNITED STATES OF AMERICA
AND THE UNITED MEXICAN STATES
FOR THE EXCHANGE OF INFORMATION WITH RESPECT TO TAXES

INTRODUCTION

This is a technical explanation of the Protocol to the Agreement between the United States and the United Mexican States for the Exchange of Information With Respect to Taxes signed on November 9, 1989 ("the Protocol"). References are made to the Agreement ("the TIEA") and to the Convention between the United States of America and the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on September 18, 1992 ("the Convention").

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

Paragraph 1

Paragraph 1 of the proposed Protocol amends the text of paragraph 4 of Article 2 (Taxes Covered) of the TIEA. Under the amended text of paragraph 1, the TIEA applies to taxes imposed by a state, municipality, or other political subdivision or local authority of a Contracting State, but not to taxes imposed by a possession of a Contracting State. The prior text provided that the TIEA shall not apply to taxes imposed by states, municipalities or other political subdivisions, or possessions of a Contracting State.

It is contemplated that information exchange under the TIEA as amended also will be the basis for exchange of information under the Convention. Article 27 (Exchange of Information) of the Convention currently requires exchange of information to take place in accordance with the TIEA unless the TIEA has been terminated. A protocol to the Convention is proposed to eliminate the cross-reference in Article 27 to the TIEA and replace it with a reference to exchange of information under any agreement between the Contracting States for exchange of information with respect to taxes. The prior text of the Convention authorized the exchange of information under a particular agreement -- the Agreement Between the United States of America and the United Mexican States for the Exchange of

Information with Respect to Taxes signed on November 9, 1989 ("the TIEA"). The effect of the proposed protocol to the Convention is to broaden the authorization for exchanging information under the terms of an agreement between the Contracting States, extending it beyond the TIEA in its current form to an amended version of the TIEA or to any new agreement or agreements.

The competent authorities under the TIEA will develop procedures and understandings to ensure the effective and efficient administration of the exchange of information for sub-federal tax purposes. Such competent authorities will also meet periodically to review the administration of the exchange of information under this proposed Protocol, as they currently do in the administration of the TIEA.

Paragraph 2

Paragraph 2 of the proposed Protocol amends paragraph 4(b) of Article 4 (Exchange of Information) of the TIEA. Paragraph 4(b) of Article 4 of the TIEA prescribes the statutory provisions of a State that are to be utilized by one State in obtaining certain financial information at the request of the other State.

The current text of paragraph 4(b) provides that, if the United States is requested to obtain the types of information covered by section 3402 of the Right of Financial Privacy Act of 1978 (12 USCA 3402) as in effect at the time of signing of this agreement, it shall obtain the requested information pursuant to that provision. In the case of the United States, 12 USC §3413(c) of the Bank Secrecy Act permits the disclosure of information pursuant to procedures authorized by Title 26 (Internal Revenue Code).

The current text of paragraph 4(b) also provides that, if Mexico is requested to obtain the types of information covered by Article 93 of the Regulatory Law of Banking and Credit Public Service as in effect at the time of signing this agreement, it shall obtain the requested information pursuant to that provision.

Paragraph 4(b) also provides that laws or practices of the requested State do not prevent or otherwise affect the authority of the competent authority of the requested State to obtain and provide the types of information covered by the above-cited provisions pursuant to the Agreement.

The proposed Protocol replaces the reference in paragraph 4(b) to the banking regulations of Mexico. Whereas the TIEA refers to Article 93 of the Regulatory Law of Banking and Credit Public Service as in effect at the time of signing the TIEA, the proposed protocol refers to Article 117 of the Credit

Institutions Law as in effect at the time of signing the protocol. The sole effect of this amendment is to replace an outdated statutory reference with the current one.

In addition, the proposed Protocol would allow certain financial information that is obtained pursuant to a provision of U.S. or Mexican law identified in the TIEA to be obtained under any similar or equivalent provision that may be added to or substituted for the provision cited in the TIEA. This change will eliminate the need to amend the TIEA if the relevant banking law is subsequently renumbered or revised.

The proposed Protocol shall enter into force upon an exchange of notes by the duly authorized representatives of the Contracting States confirming their mutual agreement that both sides have met all constitutional and statutory requirements necessary to effectuate this Protocol. The Protocol will remain in force as long as the TIEA remains in force.

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE REPUBLIC OF KAZAKHSTAN FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL SIGNED AT ALMATY ON OCTOBER 24, 1993

INTRODUCTION

This is a technical explanation of the Convention and Protocol between the United States and the Republic of Kazakhstan signed on October 24, 1993 ("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 Kazakhstan.

The Convention is based on the Model Double Taxation Convention on Income and Capital, published by the OECD in 1977 and periodically updated and amended since that time ("the OECD Model"), the 1973 Convention, and other more recent U.S. income tax conventions. The U.S. Treasury Department has withdrawn its draft Model Income Tax Convention, published on June 16, 1981, and is currently developing a new model. The Convention reflects certain principles of the withdrawn U.S. Model that were relevant 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. The explanations also take into account the mutual interpretations of certain provisions of the Convention reflected in the Memorandum of

Understanding, which was attached to a note dated August 15, 1994 from Mr. William Courtney, United States Ambassador to Kazakhstan, to Mr. Yerkishbay Derbisov, Minister of Finance, Republic of Kazakhstan, and which was referred to in the reply note from Mr. Yerkishbay to Mr Courtney dated September 13, 1994.

Article 1. GENERAL SCOPE

Paragraph 1 provides that the Convention applies to residents of the United States or Kazakhstan and, in some cases, may also apply to residents of third states. Article 4 defines a resident of the United States or Kazakhstan 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 24) and the exchange of information (Article 26).

Subparagraph 2 a) provides that the Convention may not increase the tax burden of residents of either Contracting State compared to what it would be under the State's respective domestic law provisions. Under subparagraph 2 b), the Convention also may not restrict a tax benefit conferred by any other agreement between the Contracting States.

Under this paragraph, 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 Internal Revenue Code ("Code") and Convention provisions in an inconsistent manner in order to minimize tax. For example, assume a resident of Kazakhstan 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. Of the other two trades or businesses, one is profitable, and the other incurs a loss. Under the Convention the income of the permanent establishment is taxable, but the profit or loss of the other two businesses is ignored. Under the Code, all three businesses would be taxable. The loss in the one would be offset against the profits of the other two 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 that is not effectively connected with any of his business activities in the United States.

Paragraph 3 of Article 1 contains the traditional "saving" clause, which provides that each country may tax its own residents, citizens, and former citizens, in accordance with its domestic law, without regard to the Convention. Thus, the United States may tax its citizens, wherever resident, notwithstanding any provision of the Convention (unless the provision is specifically excepted from the saving clause). The United States also may tax its residents, notwithstanding any provision of the

Convention (except a provision specifically excepted from the saving clause). A person's "residence," for the purpose of the saving clause, is determined under Article 4 (Residence). Thus, the tie-breaker rules of paragraph 2 of Article 4 will determine the residence, including for saving clause purposes, of an individual (not a U.S. citizen) who is a resident of the United States under the Code, e.g., a "green card" holder, and also a resident of Kazakhstan under Kazakh law. If the individual is determined to be a resident of Kazkahstan under these tie-breaker rules, he or she will be entitled to U.S. benefits under the Convention.

Paragraph 3 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 Code. There is not a comparable provision in Kazakh law dealing with former citizens. (Kazakhstan taxes on the basis of residence and also taxes non-residents who are employed overseas with the Kazakh government.)

As a consequence of the saving clause, each article of the Convention should be read as not providing benefits with respect to the U.S. taxation of U.S. citizens (wherever resident) or U.S. residents (as defined in Article 4) or with respect to Kazakhstan's taxation of Kazakh 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 payments and other public pensions paid by Kazakhstan under paragraph 1 b) of Article 18, the exemption of child support paid by residents of Kazakhstan as provided in paragraph 5 of Article 18, the guarantee of a foreign tax credit provided in Article 23, the non-discrimination protection of Article 24, and the competent authority procedures of Article 25. Kazakh residents are entitled to the benefits provided by Kazakhstan under the same articles (and Kazakh citizens or former citizens would be entitled to the same benefits, if relevant).

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 Kazakh Government under Article 17, to visiting students, trainees and researchers under Article 19, and to members of diplomatic and consular missions under Article 27. This paragraph also applies reciprocally.

Article 2. TAXES COVERED.

This Article identifies the U.S. and Kazakh 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. In the case of Kazakhstan, the Convention applies to the taxes on profits and income provided by the laws "On Taxation of Enterprises, Associations and Organizations" and "On the Income Tax on Citizens of the Kazakh SSR, Foreign Citizens and Stateless Persons." The non-discrimination provisions of Article 24 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 26 apply to all national level taxes (including estate and gift and excise taxes), to the extent that the information exchanged 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.

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 October 24, 1993 (the date of signature of the Convention). In recognition of the fact that the Kazakh tax system is evolving, the paragraph adds that a tax imposed by one State subsequent to the signing of the Convention 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.

On April 24, 1995, Kazakhstan enacted a new tax law by presidential decree.[1] As part of the implementation of the new law, the presidential decree orders that all existing laws be repealed or revised as necessary to bring them into conformity with the new law. The new law is generally consistent with U.S. and OECD tax policies. Its application to U.S. residents who qualify for treaty benefits will be limited by the terms of the Convention.

Paragraph 2 also provides that the U.S. and Kazakh competent authorities will notify each other of significant changes in their taxation laws that are relevant to the operation of the

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[1] The Decree of the President of the Republic of Kazakhstan, Having the Force of a Law, "On Taxes and Other Obligatory Payments to the Budget" (Almaty, April 24, 1995).

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, respectively, which deal with the taxation of those classes of income.

The term "Contracting State" means the United States or the Republic of Kazakhstan, depending on the context in which the term is used.

The terms "United States" and "Kazakhstan" 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 "Kazakhstan" means the Republic of Kazakhstan 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 Kazakh 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. 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. The Kazakh entities described in the second sentence of subparagraph e) are treated as companies, provided their profits are taxed at the entity level in Kazakhstan. In Kazakhstan, all legal entities (including a joint stock company, a limited liability company, and a joint venture), except simple partnerships and consortiums, are subject to tax on profits at the entity level. In the United States, the rules of Reg. § 301.7701-2 generally will be applied to determine whether an entity is taxed as a body corporate.

The Convention is drafted to refer to "residents" rather than "enterprises." The Kazakh delegation observed that existing models do not provide an adequate definition of an "enterprise of a Contracting State." Thus, it was decided to use instead the term "resident," for example, in Article 5 (Permanent Establishment) and Article 6 (Business Profits), obviating the need to define "enterprise."

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 the other (i.e., non-resident) State. (The operative provisions of Article 8 (Shipping and Air Transport) provide for exclusive residence State taxation of income from international shipping and air transport and are drafted such that, when the term "international traffic" is used, the "other" State always means the non-resident, source State.) The provisions of Article 8, together with the definition of "international traffic" in this Article, result in source-State exemption of income from shipping or air transport unless the transport is solely between points within the non-resident State. Thus, for example, the transport of goods or passengers by a Kazakh carrier solely between New York and Chicago (if that were permitted) would not be treated as transport in 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 Kazakh plane from Almaty to New York and then to Chicago, the trip would be in international traffic 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 purposes of Article 22 (Capital), which limits either Contracting State's ability to impose any capital taxes, including any capital taxes that may be enacted in the future.

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 Kazakhstan, 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 21 (Limitation on Benefits), 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 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 non-profit, 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. For purposes of the Convention, that person is a resident of the State in which he is resident under internal law.

In accordance with U.S. treaty and domestic tax policy, 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 Kazakhstan under its taxation law, the individual must look to the tie-breaker rules of paragraph 2, which assign one State of residence to such a person for purposes of the Convention. The U.S. citizen who is determined to be a resident of Kazakhstan under this paragraph 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 resident of Kazakhstan would not be subject to the saving clause.

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 Kazakh 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 Kazakh law, a "simple" partnership or a "consortium" is taxed on a flow-through basis, and trusts and estates generally are not used. Similarly, under U.S. law, an entity organized under a state law general or limited partnership statute generally is not, and an estate or trust often is not, a taxable entity. (Certain publicly traded partnerships and partnerships that are reclassified as associations under Reg. § 301.7701-2 will be taxable as corporations.) In addition, certain other forms of organization, such as limited liability companies, may be classified as partnerships for U.S. tax purposes. Thus, for purposes of the Convention, income received by an entity classified as a partnership for U.S. tax purposes will generally be treated as received by a U.S. resident to the extent included in the distributive share of partners or members who are themselves U.S. residents (looking through any partnerships which are themselves partners or members). 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. This could be the case, for example, where the individual is not a citizen of either Contracting State.

The tie-breaker rules of paragraph 2 apply only to individuals. Paragraph 3 seeks to settle dual residence issues for companies (defined in Article 3 as entities treated as a body corporate for tax purposes). 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 company that has its place of registration in Kazakhstan is liable to Kazakh tax by reason of that registration and therefore is a resident of Kazakhstan under paragraph 1. 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 incorporated in the United States but registered in Kazakhstan, it would be a resident of both countries under their respective domestic laws. Paragraph 3 provides that, in that event, 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 other persons who are entitled to Convention benefits (i.e., those who receive dividends, interest or royalties from the dual resident and who are entitled to the treaty's reduced rates of source country tax on those items of income) 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 or had in the source State; if the income is attributable to a permanent establishment, Article 6 (Business Profits) applies (and if the income is attributable to a fixed base, Article 14 (Independent Personal Services) applies).

This Article is similar in most respects to the corresponding articles of the OECD Model and conforms with U.S. treaty policy. It does, however, depart from that Model and those policies in certain respects.

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. Point 1 of the Protocol makes clear that it is also unnecessary that the fixed place of business be owned by the resident. 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 permanent establishments: 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). Mines, wells, or quarries are examples of fixed places that may not be owned by the resident of the other State but that can nonetheless form a permanent establishment of that resident.

Paragraph 3 adds that a construction site, installation or assembly project, or an installation or drilling rig (onshore or offshore) 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 is the period provided for in the OECD Model, and it is consistent with U.S. treaty policy. The 12-month test applies separately to each individual site or project. 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 were constructed for a different purchaser. Similarly, 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.

The 12-month 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. If the 12-month threshold is exceeded, the site or project constitutes a permanent establishment from the first day.

The foregoing interpretation of paragraph 3 is based on the Commentaries to paragraph 3 of Article 5 of the OECD Model, which constitutes the generally accepted international interpretation of the language in paragraph 3 of Article 5 of the Convention.

The furnishing of supervisory services may give rise to a permanent establishment under paragraph 3. Supervisory services that do not themselves last for more than 12 months may nonetheless be an interrelated part of a construction 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 is carried on for purposes of determining whether the building contractor meets the 12-month test. Supervisory services may be performed by the building contractor or by another enterprise (e.g., a subcontractor). If the services are performed by another enterprise, then such services may also constitute an independent permanent establishment of that other enterprise if they continue for more than 12 months. The addition of the reference to supervisory services generally is consistent with the OECD Model. The commentary to paragraph 3 of Article 5 of the OECD Model points out that activities of planning and supervision, as well as activities of subcontractors, are taken into account in determining whether the general contractor has a permanent establishment.

The furnishing of services, including consultancy services, by a resident of one Contracting State through employees or other personnel in the other State will give rise to a permanent establishment if such services last for more than 12 months. As is true with respect to the type of permanent establishment created through a construction project, time spent performing services with respect to the same or related service projects will be aggregated for purposes of applying this 12-month threshold. Although the preferred U.S. treaty policy is that services do not give rise to a permanent establishment unless performed through a fixed place of business or by a dependent agent, the United States has agreed to similar provisions in

other treaties with developing countries (for example, India and Indonesia and, more recently, the Czech Republic and the Slovak Republic). Moreover, the 12-month threshold agreed to in this Convention is much longer than the 183 days that the United States has accepted in these other treaties. The U.N. Model also contains a shorter period of an aggregate of 6 months in a 12 month period.

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 a resident will not constitute a permanent establishment of that resident. The maintenance of a stock of goods belonging to a resident solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another resident will not give rise to a permanent establishment of the resident. 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 supplying of information, or the conduct of certain research activities, will not constitute a permanent establishment of the resident.

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 a resident of one State will be deemed to be a permanent establishment of that resident in the other State if the agent has and habitually exercises an authority to conclude contracts in the name of the resident. If, however, the agent's activities are limited to those activities specified in paragraph 4 that would not constitute a permanent establishment if carried on directly by the resident through a fixed place of business, the agent will not be a permanent establishment of the resident.

Under paragraph 6, a resident of one State will not be deemed to have a permanent establishment in the other State merely because it carries on business in the other State through an independent agent, including a broker or general commission agent, as long as 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 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 two.

Article 6. BUSINESS PROFITS

The location of this Article (and the articles on real property income and related persons) is different from the OECD Model and other U.S. treaties. Nothing substantive is intended by this ordering of the subject matter, which merely reflects the suggestion that it is more logical.

Article 6 provides the rules for the taxation by a Contracting State of the business profits of a resident of the other Contracting State. Currently, the rate of tax on profits in Kazakhstan is 30 percent, and the rate on corporate profits in the United States is 35 percent.

Paragraph 1 states the general rule that business profits (as defined in paragraph 6) 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 the other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated in that other State. Where that condition is met, the other State may tax the business profits attributable to the assets or activity of the permanent establishment. The State in which the permanent establishment is situated may also tax the business profits derived from the sales in that State of goods or merchandise of the same kind as those sold through the permanent establishment and the business profits from the resident's other business activities in that State if the activities are the same kind as those performed through the permanent establishment. The latter rule derives from the U.N. Model and is similar to provisions that appear in the United States treaties with Mexico, Indonesia, and India. It amounts to a partial "force of attraction," by attributing to the permanent establishment sales of goods or performance of services by the home office if the goods or services are the same kind as those sold or performed, respectively, through the permanent establishment. This "force of attraction" attributes profits to the permanent establishment whether or not the assets and activities of the permanent establishment were involved in the sale or performance. Such a "force of attraction" rule is often requested by developing countries to prevent avoidance of their tax at source, although it is not the preferred U.S. position.

Paragraph 1 incorporates the rule of section 864 (c)(6) of the Code with respect to deferred payments. Thus, 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. This same approach is reflected in the provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 14 (Independent Personal Services) dealing with amounts attributable to a permanent establishment or fixed base.

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.

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 resident of Kazakhstan and be 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 it is broader than the rule of subparagraphs b) and c) 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, as long as the expenses were incurred on behalf of the resident's business enterprise as a whole or a part of it that includes the permanent establishment and as long as the expenses relate to the business activities of the resident. 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.

To ensure continuous and consistent tax treatment, paragraph 3 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 3 also clarifies, as does the U.N. 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 or any other office of the resident. There was no intention, however, to deny deductions for such payments when they are made as reimbursement of actual expenses incurred by the home office or another office. The point of this provision is to clarify that, because the home office and the permanent establishment are parts of a single entity, there should be no profit element in intra-company transfers.

Point 8 b) of the Protocol ensures that Kazakhstan will permit a full deduction of interest expense in computing the profits of a U.S. resident's permanent establishment in Kazakhstan. Kazakhstan is not, however, required to allow a deduction for interest in excess of any limitation specified in Kazakh law, as long as that limit permits deduction of an arm's length interest rate, taking into account a reasonable risk premium.

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 may 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 of this Article applies where the information available either from the taxpayer or through competent authority is insufficient to calculate business profits under the other provisions of the Article. In particular, paragraph 5 applies where there is insufficient information concerning expenses. In that event, either Contracting State may apply its internal laws to determine the profits of the permanent establishment. These internal laws may make assumptions about expenses and thus may

estimate profits, rather than compute them with complete certainty.

The Memorandum of Understanding between the Contracting States makes clear that paragraph 5, and thus any internal law of either country that presumes expenses, may not be applied if books and records audited by a certified public accountant are available. In that case, the audited books and records will be considered adequate for calculating actual profits, and it will not be necessary--or permissible--to resort to presumptions. In addition, paragraph 5 itself provides that information will be considered readily obtainable by the competent authority if the taxpayer provides the information within 91 days of that competent authority's written request. This provision effectively establishes the procedure to be followed by a competent authority before it may invoke this paragraph to apply any internal law, and it ensures that the taxpayer is consulted and given an opportunity to cooperate.

Paragraph 6 illustrates the meaning of the term "business profits," as it is used in this Article. The term includes income from manufacturing, mercantile, transportation, communication, or extractive activities (including the operation of a mine), as well as income from the furnishing of the services of others. It does not include income from the rental of tangible personal property or income from the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting. Compensation received by an individual for his or her personal services, whether the individual is self-employed or an employee, is not within the scope of "business profits." Rather, that compensation is covered by Article 14 (Independent Personal Services) if the individual is self-employed or by Article 15 (Income from Employment) if the individual is an employee.

Paragraph 7 coordinates the provisions of this Article and other provisions of the Convention. Under paragraph 7, 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 4 of Article 11, the interest is attributable to a permanent establishment, in which case the provisions of Article 6 will apply.

Article 7. ASSOCIATED ENTERPRISES

This Article allows the Contracting States to make appropriate adjustments to the taxable income and tax liability of related persons that engage in non-arm's length transactions

with one another. The Article provides that the States may make such adjustments as are necessary to reflect the income or tax that each party to the transaction would have had if the transaction had been at arm's length.

Paragraph 1 a) 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, and paragraph 1 b) deals with a situation in which the same persons participate, directly or indirectly, in the management, control, or capital of a resident of one of the Contracting States and of any other person. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable. If, in either of these related party cases, there are commercial or financial dealings that do not reflect arm's length terms or conditions, the competent authorities may adjust the income of their residents to reflect an arm's length transaction.

The adjustments allowed by the provisions of paragraph 1 can give rise to taxation of the same income by both Contracting States. To address this potential double taxation, paragraph 2 provides that, where a Contracting State has made an adjustment to the income of one of its residents to reflect arm's length terms, the other Contracting State will make a corresponding adjustment to the tax liability of a related person resident in that other State. 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 2 of Article 25 (Mutual Agreement Procedure) explains that the corresponding adjustment by the other Contracting State will not be prevented by a domestic statute of limitations or other procedural limitation. The "saving clause" of paragraph 3 of Article 1 (General Scope) does not apply to paragraph 2 of Article 25. (See Article 1 (4)(a).) Thus, even if the statute of limitations has run or if there is a closing agreement between the Internal Revenue Service and the taxpayer, a refund of tax may be required to implement a corresponding 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.

Paragraph 3 simply confirms this Article 7 does not restrict the application of either Contracting State's domestic laws that adjust the income of 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 tax liability. Adjustments to the elements of tax liability are permitted even if they are different from, or go beyond, those authorized by paragraph 1 of this Article, as long as they accord with the general principles of paragraph 1, i.e., the adjustments reflect what would have transpired had the related parties been acting at arm's length.

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. This Article, rather than Article 6 (Business Profits), applies even if a resident of one State has a permanent establishment in the other State to which profits from the operation of ships and aircraft in international traffic are attributable.

"International traffic" is defined in subparagraph 1 f) of Article 3 (General Definitions). Income from the operation of ships or aircraft in international traffic, when derived by a resident of either Contracting State, may be taxed only by that State, the country of residence. The other Contracting State must exempt the income from tax, even if the income arises in or is attributable to a permanent establishment in that State. The only circumstance in which the non-resident State may tax income from the operation of ships or airplanes is when the income arises from transport solely between places in that State (i.e., only when the income is not derived from operation in "international traffic" as defined in paragraph 1 f) of Article 3).

Income from the rental of ships or planes on a full basis for use in international traffic is considered operating income and is taxable only in the country of residence. Income from the bareboat leasing of ships or planes is also exempt from tax at source if the ship or aircraft is 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 rule applies even to a leasing company. However, if the lessor is an operating company, and the income is incidental to income from such operations, the exemption from source State taxation 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 a Kazakh airline were to form a consortium with other national

airlines, the Kazakh 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 a 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 airplanes.

Paragraph 3 clarifies that the Article covers income from any use of real property, without regard to the form of use or lease.

Paragraph 4 provides for a binding election by the taxpayer to be taxed on a net basis. The election is based on U.S. treaty policy and reflects U.S. law. Because this Article provides for net basis taxation, it generally provides the same tax result as Article 6 (Business Profits).

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 to its parent company. Notwithstanding the source State's treaty obligation to limit the rate of tax it applies to dividends, that State may, in accordance with point 4 of the Protocol, withhold on dividends at the applicable domestic rates, as long as the State timely refunds any excess amount withheld over the maximum rates established by the treaty.

Paragraph 1 of Article 10 preserves the general right of a Contracting State to tax its residents on dividends received from 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 point 2 of the Protocol (discussed below), paragraph 2 also permits the source State to tax a dividend but limits the rate of source State tax that may be imposed on dividends paid to a resident of

the other State. When the beneficial owner of the dividend is a company resident in the other State that owns at least 10 percent of the voting stock of the paying corporation, the maximum source rate is 5 percent. In other cases, the source State tax is limited to 15 percent of dividends beneficially owned by residents of the other State.

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. It also includes 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 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 of dividends in this Article also confirms that distributions by a Kazakhstan joint venture to the venturer's 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 14 (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 are attributable to a permanent establishment or fixed base that did exist in an 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 and may be applied not only where there is a permanent establishment but also where the source State applies a net basis tax in accordance with other articles of the Convention. The additional tax is imposed on the "dividend equivalent amount" of profits, at the 5 percent rate that would apply to dividends paid by a wholly-owned subsidiary corporation to its parent. 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. Point 2 b) of the Protocol explains the meaning of the term "dividend equivalent amount," and, in the case of the United States, defines the term consistently with U.S. law. Kazakhstan's new tax law, enacted by presidential decree on April 24, 1995, imposes a branch tax at

the rate of 15 percent, which will be reduced by the treaty to 5 percent.

Paragraph 2 a) of the Protocol also relaxes the limitations on source country taxation for dividends paid by a U.S. Regulated Investment Company (RIC) or a 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 by the recipient of the dividend. The 5-percent direct investment rate is intended to relieve multiple levels of corporate taxation. A RIC, however, pays no corporate-level tax on income it distributes to shareholders, and, to maintain its tax-favored status, RICs typically do distribute substantially all of their income. There is, therefore, effectively, no corporate-level RIC tax; the shareholder-level tax is the only U.S. tax imposed on the RIC's income. 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, effectively converting a portfolio dividend into a direct investment dividend without incurring any additional tax.

In the case of a dividend paid by a REIT, the treaty does not limit the rate of tax that may be applied. Thus, in the case of the United States, a 30 percent tax will apply to REIT distributions. 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 Convention, however, the single statutory rate of 30 percent will apply to all REIT dividends.

Article 11. INTEREST

This Article governs the taxation of interest. The ability of the residence State to tax interest is provided by paragraph 1 and also preserved by the saving clause of paragraph 3 of Article 1 (General Scope). Interest derived from one Contracting State and beneficially owned by a resident of the other State may also be taxed by the first (source) State. However, as provided in paragraph 2, the tax imposed by the source State may not exceed 10 percent. This reduced rate does not apply to back-to-back loans. Notwithstanding its treaty obligation to limit the rate of tax applied to interest, the source State may, in accordance with point 4 of the Protocol, withhold on interest at its domestic rates, as long as it timely refunds any excess amount withheld over the maximum rates established by the treaty.

In the absence of the Convention, Kazkhstan's withholding rate on interest paid to a U.S. resident (and not attributable to a permanent establishment of that resident in Kazakhstan) would

be 15 percent. The general U.S. statutory rate on payments of interest to nonresidents is 30 percent, with an exemption for portfolio interest.

The preferred U.S. treaty policy is source country exemption of interest paid to a resident of the other country. This policy coincides with U.S. internal law, which generally exempts interest paid to nonresidents from U.S. tax. It is not uncommon, however, particularly in treaties with developing countries, for the United States to agree to some source country tax. Point 3 a) of the Protocol provides that, if Kazahkstan agrees in a treaty between it and another country that is a member of the OECD to impose a rate at source on interest lower than the 10 percent provided for in this Convention, this Convention will be promptly amended to incorporate that lower rate. The amended Convention would then be submitted to the United States Senate for its acceptance of the lower rate (see also, point 4 of the Memorandum of Understanding).

As the term "interest" is not specifically defined in the Convention, its meaning depends upon the domestic law of the State whose tax is being applied (see paragraph 2 of Article 3 (General Definitions)). The term is used in the Convention in the usual sense to refer to income from debt claims of every kind other than those giving rise to dividends under paragraph 3 of Article 10 (Dividends). Penalties and fines for late payment are generally not included in the treaty concept of interest; such amounts may be imposed in accordance with domestic law.

Paragraph 3 specifies two categories of interest that, notwithstanding the provisions of paragraph 2, are exempt from tax at source when the beneficial owner is a resident of the other State. Those categories are: (i) interest paid or beneficially owned by either Contracting State or any political subdivision or local authority thereof or any government instrumentality agreed upon by the competent authorities, and (ii) interest on loans of three years or longer that are made, guaranteed, or insured by a specified public lending institution. Point 3 b) of the Protocol provides that the lending institutions to which loans in (ii) will apply are the Export-Import Bank, the Overseas Private Investment Corporation of the United States, and any other similar agencies that are agreed upon in the future by the competent authorities. Point 3 b) of the Protocol further provides that there will be no required exemption for loans made or guaranteed by these institutions if the lender has a right of recourse against any person other than the borrower or a governmental body in the borrower's country. This Point arose from Kazakhstan's view that the exemption should not cover internal group financing or loans to joint ventures in which there are other foreign participants besides the U.S. venturers.

Paragraph 4 provides an exception from the rules of paragraphs 1, 2, and 3 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 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 paid or accrued in the earlier year.

Paragraph 5 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). In addition, interest paid by any person (whether or not a resident) and borne by a permanent establishment or fixed base or other activity giving rise to income subject to tax on a net basis in the non-residence State under the Convention (e.g., income from real property under Article 9, certain royalty income under paragraphs 2 and 3 b) of Article 12, and gains under paragraph 1 or 2 of Article 13) is considered to arise in that State. For this purpose, interest is considered to be "borne by" a permanent establishment, fixed base, or other trade or business if it is allocable to (whether or not deductible from) taxable income of that permanent establishment, fixed base, or trade or business. If the actual amount of interest on the books of a U.S. branch of a Kazakh business 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. Conversely, the total amount of interest allocated to the branch under that regulation will be U.S. source even if the amount exceeds branch book interest.

The source rules in paragraph 5, as applied to interest paid by Kazakh corporations conducting business in the United States through a permanent establishment or fixed base, are consistent with the rules contained in Treas. Reg. § 1.884-4, which treat interest allocable to the U.S. trade or business of a foreign corporation under Treas. Reg. § 1.882-5 as if such interest were paid by a domestic corporation and, thus, sourced in the United States. The presence of this source rule confirms that interest paid by a U.S. permanent establishment of a Kazakh corporation, within the meaning of section 884(f)(1)(A) of the Code, is subject to a 10 percent rate of tax pursuant to paragraph 2 where such interest is paid to a resident of Kazakhstan.

Paragraph 6 provides that if, as a result of a special relationship between persons, the amount of interest paid is excessive, Article 11 will apply 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).

Point 3 c) 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 U.S. domestic law; thus, the tax on such an excess inclusion of a resident of Kazakhstan would be subject to the domestic rate of withholding tax, now 30 percent.

Paragraph 7 clarifies that the United States may also impose a tax on the "excess interest amount" of a Kazakh resident that conducts business in the United States through a permanent establishment or fixed base or derives income in the United States that is otherwise subject to tax on a net basis under the Convention. Paragraph 7 limits the rate of such tax, however, to not more than 10 percent of the "excess interest amount." This is the same rate that applies to interest under paragraph 2.

The "excess interest amount" is defined in point 3 d) of the Protocol to coincide with the provisions of Code section 884(f)(1)(B). Accordingly, the United States may apply its tax on excess interest (but at the lowered treaty rate) to the excess, if any, of (i) interest borne by a U.S. permanent establishment, fixed base, or other trade or business of a Kazakhstan resident subject to tax on a net basis over (ii) the interest paid by such permanent establishment, fixed base, or trade or business. (The interest would be U.S. source under paragraph 5 because it is borne by a U.S. branch.) Under current U.S. law, the excess amount is deemed paid by a U.S. corporation to a Kazakhstan corporation. Moreover, current U.S. law imposes branch level interest taxes only on foreign corporations and not on non-corporate foreign residents. Interest will be considered "borne by" a permanent establishment even if the interest is not fully deductible in that year, provided it is allocable in that year to the permanent establishment's U.S. income under U.S. domestic rules.

Unlike the United States, Kazakhstan does not currently impose a tax on excess interest comparable to the U.S. tax on excess interest. The provisions permitting application of a tax on an excess interest amount, however, are drafted reciprocally.

Should Kazakhstan enact a tax on excess interest, the "excess interest amount" to which it could apply that tax would be limited to the amount of interest deductible in computing the profits of a Kazakh branch of a U.S. resident, provided the amount were similar to the amount that would be "excess interest" under U.S. law.

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 State'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 permits the source State to tax royalties but limits the rate of source State tax to 10 percent of the gross amount of royalties beneficially owned by residents of the other State. Notwithstanding its treaty obligation to limit the rate of tax applied to royalties, the source State may, in accordance with point 4 of the Protocol, withhold on royalties at its domestic rates, as long as it timely refunds any excess amount withheld over the maximum rates established by the treaty.

As defined in paragraph 3, the term "royalties" includes payments for equipment rentals. (Payments for the rental of ships, aircraft, and containers in connection with international traffic, however, are covered by Article 8 (Shipping and Air Transport).) Paragraph 2 provides that the beneficial owner of royalties arising from equipment rentals may elect to compute the source State tax on a net basis, as if the royalties were attributable to a permanent establishment or fixed base. In that case, the 10 percent maximum rate of paragraph 2, which limits any _gross_ basis tax, will not be applicable. The election effectively treats income from the leasing of equipment as if it were attributable to a permanent establishment in the source State and covered by Article 6 (Business Profits). The preferred U.S. position is in fact to treat income from the rental of tangible personal property under Article 6. A beneficial owner of the payments from equipment rentals that makes the net election may, in addition to the source State tax on profits, be subject to any source State branch taxes under paragraph 5 of Article 10 (Dividends) or paragraph 7 of Article 11 (Interest).

Paragraph 2 further 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. 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 information concerning industrial, commercial, or scientific experience. The term "information concerning industrial, commercial, or scientific experience" alludes to the concept of "know-how" and means information that is not publicly available and that cannot be known from mere examination of a product and mere knowledge of the progress of technique. As provided in the Commentaries to the OECD Model (Paragraph 11 of the Article 12 Commentaries), "In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public." This distinguishes the "know-how" contract from a contract for the provision of services or technical assistance, in which one party agrees himself to perform work for the other party.

Paragraph 4 provides an exception to the rules of paragraphs 1 and 2 in cases where royalties are attributable to a permanent establishment or fixed base that the beneficial owner, a resident of one Contracting State, has in the other Contracting State. 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 14 (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 would have been attributable to it if they had been paid or accrued in the earlier year.

Paragraph 5 provides a source rule for royalties that reflects the U.S. rule. That is, royalties will be deemed to arise in a Contracting State, and thus may be taxed there in accordance with the provisions of paragraph 2, if they are paid for the use or right to use in that State property giving rise to the royalty.

Paragraph 6 provides that if, as a result of a special relationship between persons, the royalty paid is excessive, Article 12 will apply 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 Kazakhstan, 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 would be subject, if appropriate, to the rate limitations of paragraph 2 of Article 10 (Dividends).

Article 13. 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 real 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 non-discriminatory treatment under Article 24 (Non-discrimination).

Paragraph 2 elaborates, in effect, on the rule of paragraph 1 by permitting each State to tax gains from the alienation of real property held not only directly but also indirectly through a corporation, partnership, trust, estate, or other legal person. Thus, to the extent the property of a corporation or other legal person consists principally of real property situated in a Contracting State, gain on the alienation of an interest in that corporation or other person may be taxable by that State. This is true whether or not the corporation or other legal person is itself resident of that State. Subparagraph b) of paragraph 2 provides similar treatment for gain on the alienation of an interest in a partnership, trust, or estate (again, whether or not it is a resident of a Contracting State) to the extent the gain is attributable to real property situated in a Contracting State. The term "real property" for purposes of paragraph 2 includes the shares of any company and the interest in any partnership, trust, or estate referred to in the paragraph. It also specifically includes a "United States real property interest" as defined in Code section 897 or any successor to that provision.

Paragraph 3 provides a rule similar to provisions in the United States treaties with Spain and Mexico. It permits a Contracting State to tax the gain derived by a resident of the other State on the disposition of shares or other rights in the capital of a corporation or other legal person resident in the first State. The right to impose this tax, however, is permitted only if the person disposing of the shares has or had at any time during the 12-month period preceding the disposition a direct or indirect interest of at least 25 percent in the vote or value of the corporation or other legal person. At present, neither the United States nor Kazakhstan imposes a tax on the alienation by a nonresident of shares in a local corporation or other legal person. This paragraph, therefore, currently has no practical effect. Point 6 of the Protocol provides that, in the event either State introduces such a tax in the future, it must inform the other State in a timely manner and must consult with that other State with a view to providing for nonrecognition treatment in appropriate cases. The cases envisioned were those involving corporate reorganizations and other intercompany transfers. The negotiators believed it prudent to postpone consideration of nonrecognition provisions until such time as actual laws make

clearer what exceptions and allowances are necessary. Moreover, views within each Contracting State on the types of transactions that are appropriately excepted from current taxation may change. Thus, elaborate nonrecognition provisions of the type that appear in the United States treaties with Spain and Mexico are not provided in the present agreement, but the Convention does impose a good faith obligation to craft such exceptions in the event domestic laws change. It is expected that the corresponding provisions in the treaties with Mexico and Spain will serve as guidance in the crafting of exceptions in this Convention.

To the extent one State does tax the share gains of residents of the other State as permitted by paragraph 3, the residence State will source the gains in the non-residence State to the extent necessary to permit a foreign tax credit or otherwise avoid double taxation.

Paragraph 4 provides that gain from the alienation of personal property attributable to a permanent establishment or fixed base that a resident of one Contracting State has in the other Contracting State may be taxed by that other State. Gain from the alienation of personal property comprising part or all of the assets of the permanent establishment or fixed base also may be taxed by that other State. Paragraph 4 does not permit the United States to impose tax under Code section 864(c)(7) with respect to gain from the subsequent disposition of assets that were formerly used in connection with a U.S. permanent establishment or fixed base. Kazakhstan does not tax gain in such circumstances.

Paragraph 5 provides that gains derived by a resident of one of the Contracting States from the alienation of ships, aircraft, containers, or related equipment operated in international traffic may be taxed only by that State. Occasional use of a ship, aircraft, container, or related equipment in domestic traffic should not cause the disposition of such property to fall outside the scope of this provision.

Paragraph 6 reserves the exclusive right to tax gains with respect to any property not specified in the previous paragraphs of this Article to the State in which the alienator is a resident.

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, sometimes referred to as dependent personal services. Articles 16 through 19 provide exceptions and additions to these general rules for directors' fees (Article 16); government

service salaries (Article 17); pensions and social security benefits (Article 18); and certain income of students, trainees and researchers (Article 19).

Unlike the OECD Model and certain other U.S. treaties, this Convention does not provide a separate article dealing with entertainers and athletes. Like the OECD Model and other U.S. treaties, the Convention does not provide a separate rule for the remuneration of teachers. (See the discussion under Article 19 (Students, Trainees, and Researchers.)) The compensation of such individuals is taxable under this Article or Article 15 (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 is exempt from tax in that other State unless one of two conditions is met. The income may be taxed in that other State if the services are or were performed there (see Code section 864(c)(6)) and if the income is attributable to a fixed base that the individual regularly used or uses in that other State in performing services. Alternatively, if the individual is or was present in that other State for more than an aggregate of 183 days in any twelve month period beginning or ending in the taxable year concerned, that other State may tax the income attributable to the activities performed there, whether or not there is a fixed base. 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 6 (Business Profits). In particular, the income attributed to the services 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 for the taxation of business profits of a permanent establishment. However, the nonresident State may only tax income that is attributed to services performed in that State and may not in any case tax income from services performed elsewhere.

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.

Article 15. INCOME FROM EMPLOYMENT

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. Paragraph 1 also provides that the more specific rules of Articles 16 (Directors' Fees), 17 (Government Service), and 18 (Pensions, Etc.) apply in the case of employment income described in one of those articles. Thus, even though the State of source has a right to tax employment income generally 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, these other articles may expand the source State's right to tax beyond the circumstances in which Article 15 would permit it to tax.

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 achieved by the saving clause of paragraph 3 of Article 1 (General Scope). Under paragraph 2, the remuneration also may be taxed by the other Contracting State if the remuneration is derived from the performance of services in that other State and if one of the following is true: (1) the individual is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period beginning or ending in the taxable year concerned; (2) the remuneration is paid by, or on behalf of an employer who is a resident of that other State; or (3) the remuneration is borne as a deductible (or capitalizable) expense 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, either condition (2) or (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. Failure to satisfy any of the three conditions will result in exclusive residence State taxation of employment income.

Paragraph 3 contains a special rule exempting income from tax at source in one particular case. That case involves remuneration for services performed as an employee aboard a ship or aircraft operated in international traffic.

Article 16. 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 or her capacity as a director of the company. For this purpose, "similar payments" includes fixed salaries (or the

portion thereof) paid for services performed as a director (not to include any portion of such salary paid for performance as an officer).

Article 17. 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 or local authority to compensate an individual for performing governmental services may be taxed only by that State. However, if the services are rendered in the other State by an individual who is either a citizen of that other State, or was a resident of that 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.

The rules of paragraph 1 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 Kazakhstan to its employees at the Kazakh Embassy in Washington, D.C. 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 Kazakhstan, 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, because time spent in the United States as a foreign government employee does not count in applying the physical presence test of residence.)

Paragraph 2 provides that this Article applies only to remuneration paid in respect of services of a governmental nature. Remuneration paid in respect of services for a government-conducted business (for example, a government-operated airline) are covered by Articles 14 (Independent Personal Services) or 15 (Income from Employment), as appropriate.

This Article does not cover pensions paid to individuals in respect of services rendered to the government of one of the Contracting States. Such payments are covered instead in Article 18 (Pensions, Etc.).

Article 18. PENSIONS, ETC.

The general rule of this Article is that 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 Kazakhstan would be exempt from taxation 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 b) of paragraph 1 provides the first exception to the general rule, that 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 Kazakh 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, Kazakhstan, or a third country).

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. The rules of paragraph 2 do 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 exclusively by the source State under the terms of paragraph 1 b). However, paragraph 2, in particular subparagraph b), 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. Thus, in the unusual case where a Kazakh citizen and resident derives a pension for U.S. Government employment that is paid under the social security system, only Kazakhstan may tax that pension, as provided by paragraph 2 b). This could happen, for example, if a locally hired driver for the U.S. Embassy in Almaty were to retire and receive a U.S. pension under social security.

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 that 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.

Paragraph 4 provides for exclusive residence State taxation of alimony payments. The term "alimony" is defined by paragraph 4 to mean periodic payments made pursuant to a written separation

agreement or decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of residence. Under U.S. law, alimony payments are taxable to the recipient (and deductible by the payer). Kazakhstan does not tax the recipient of alimony (nor does it permit a deduction by the payer). In general, "alimony" payments are made in Kazakhstan solely for the support of children, and there is no concept of payments made solely for the support of a spouse or former spouse.

Paragraph 5 addresses child support payments and provides for exclusive source State taxation. Thus, when a resident pays child support to a resident of the other State, only the first-mentioned State may tax the payment. This rule is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a U.S. resident deriving child support payments from a resident of Kazakhstan will be exempt from any U.S. tax on those payments. Under the laws of both the United States and Kazakhstan, child support payments are not taxable to the recipient in any case (and are not deductible by the payer).

Article 19. 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 the host 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 from the coverage of this paragraph full-time students who, in accordance with their visas, may hold part-time employment. For U.S. purposes, a religious, charitable, etc. organization as described in paragraph 1 c) means an organization that qualifies as tax-exempt under Code 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 in the host State 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 became 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 Kazakh 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 20. OTHER INCOME

This Article provides the rules for the taxation of items of income derived by a resident of a Contracting State and arising in the other Contracting State that are not dealt with in the other articles of the Convention. Such income includes lottery winnings, punitive damages, and cancellation of indebtedness income. 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. Thus, 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 6 (Business Profits) or 14 (Independent Personal Services) applies.

Article 21. LIMITATION ON BENEFITS

Article 21 addresses the problem of "treaty shopping" by assuring 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. In a typical case of treaty shopping, 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. Article 21 limits the abuse of the Convention by limiting the benefits of the Convention to those persons whose residence in a Contracting State is not considered to have been motivated by the existence of the Convention.

Absent Article 21, 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) applicable to a particular transaction or arrangement. Article 21 and general anti-abuse provisions complement each other, as Article 21 generally determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while general anti-abuse provisions determine whether a particular transaction should be recast in accordance with the substance of the transaction.

Article 21 follows the form used in other recent U.S. income tax treaties. See, e.g., the 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, 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).

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 illustrate the situations covered by subparagraph (b).

The third category, in subparagraph (c), 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. Point 7 of the Protocol specifies that the term "officially recognized securities exchange" means, in the case of the United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc., and any stock exchange registered with the Securities Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934. The Memorandum of Understanding between the two States provides that any other exchange will be treated as an "officially recognized exchange" under subparagraph (c) only if it is officially recognized by either State and agreed upon by the competent authorites of both States. This clarifies that point 7 neither limits the U.S. exchanges that may be "officially recognized" under paragraph 1 (c) to those specified in the Protocol nor implies that any exchange recognized by Kazakhstan is automatically within subparagraph (c). Thus, any future exchange officially recognized by Kazakhstan will be reviewed by the competent authorites and, only if they agree that it provides adequate requirements for listing and trading, will be treated as an "officially recognized exchange" for purposes of granting treaty benefits to companies listed and traded on it.

The fourth category covers tax-exempt organizations. If more than half of its beneficiaries, members, or participants (if any) are individual residents of either Contracting State or persons who meet the other criteria of this Article, the tax-exempt organization will be a qualified resident.

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 treaty 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 taxpayer 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 21.

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 22. 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. At the time the treaty was signed, neither the United States nor Kazakhstan imposed a national-level tax on capital. There was some indication, however, that Kazakhstan might enact such a tax, and the purpose of this Article was to provide rules to deal with any such tax subsequently enacted by either State. The recently enacted tax code of Kazakhstan contains provisions for capital taxes on land, vehicles, and certain business assets. This Article specifically permits Kazakhstan to impose a capital tax on real property (as defined in Article 9 (Income from Real Property)) of a U.S. resident situated in Kazakhstan (paragraph 1) and on movable business assets forming part of the permanent establishment or fixed base of a U.S. resident in Kazakhstan (paragraph 2). Paragraphs 1 and 2 would also permit the United States to impose capital taxes on real property of a Kazakhstan resident located in the United States and on a Kazakhstan resident's business assets held in connection with a permanent establishment or fixed base in the United States. In the cases covered by paragraphs 1 and 2, the taxing right given to the State where the capital is

located is not an exclusive right; the State of residence may also tax.

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 (Shipping and Air Transport) that addresses the income from international transportation activities.

Paragraph 4 provides that all other items of capital not otherwise specified in the Article will be taxed exclusively by the residence State. For this purpose, a "resident" is defined under Article 4 (Residence). Thus, for example, a U.S. citizen may be a "resident" of Kazakhstan and would be subject to capital taxes in Kazakhstan under paragraph 4 but would also be subject to any capital tax in the United States under the saving clause of paragraph 3 of Article 1 (General Scope).

Article 23. 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 that is a resident of the other State) for tax "indirectly" paid to that other State. Each Contracting State uses the foreign tax credit 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 59(a), 902, and 904.

Point 8 of the Protocol further elaborates on the provisions in this Article. Subparagraph (a) of point 8 provides that Kazakhstan will credit the U.S. tax imposed on U.S. citizens resident in Kazakhstan by reason of citizenship, subject only to the limitation to the amount of the Kazakh tax on non-Kazakhstan source income. This includes the portion of the U.S. 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 with respect to U.S. source income and third-country source income of a U.S. citizen who is resident in Kazakhstan. 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.)

Kazakhstan confirms in point 8 b) of the Protocol that, in computing the taxes on profits and income specified in Article 2 (Taxes Covered), it allows certain deductions to a Kazakh entity wholly owned by U.S. residents, to joint ventures involving U.S.

investors, and to permanent establishments of U.S. residents. The deductions specified in point 8 b) are the amount of wages actually paid and interest, whether or not paid to a bank and without regard to the term of the debt. The amount of interest allowed as a deduction, however, shall not exceed the limitation on interest deductions under Kazakhstan law, as long as the limitation permits deduction of at least an arm's length rate of interest, with a reasonable risk premium.[2] (Kazakhstan's new tax law, which was enacted by presidential decree on April 24, 1995, makes no distinction between foreign and domestic ownership for purposes of interest and wage deductions and generally permits full deduction of these expenses.)

Based upon the confirmation of deductions in point 8 b) of the Protocol, Article 23 provides that the Kazakhstan taxes referred to in Article 2 shall be treated as income taxes, and therefore are eligible for the foreign tax credit. Thus, when those Kazakhstan taxes are paid by ventures wholly or partly owned by U.S. investors, they will be eligible for foreign tax credits in the United States.

The deductions for wages and interest are critical to the agreement by the United States to provide a foreign tax credit for the Kazakh taxes covered under Article 2. The United States permits a credit only for foreign taxes imposed on net income, and the deduction of wages and interest is necessary to ensure that the base of the Kazakh tax is net income. Kazakhstan has an obligation under Article 2 (Taxes Covered) to notify the United States, through the competent authority mechanism, of significant changes in its law, including changes that deny or have the effect of denying, these significant deductions. The United States will not be obligated under the Convention to grant a foreign tax credit should Kazakhstan change its law in the future to deny these deductions. Moreover, the United States may, without regard to any treaty obligation, make an independent assessment of any other substantial change in Kazakh law to ensure that the Kazakh tax remains creditable under principles of U.S. domestic law.

Subaragraph c) of Point 8 of the Protocol provides that income tax paid by a Kazakh person that is treated as a partnership under U.S. principles will be treated by the United States as having been paid by the U.S. partners, pursuant to the

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[2] Point 8 b) does not alter the general rule under Article 6 (Business Profits) that deductions will not be allowed for interest paid by a permanent establishment to the home office. Consequently, in accordance with Article 6 (Business Profits), a permanent establishment will be allowed to claim deductions for interest expenses only to the extent they are reasonably allowable to the permanent establishment.

rules of the Code. The Code rules regarding foreign taxes paid or accrued by a partnership are found in sections 702 and 901 and in Treas. Reg. § 1.901-1(a). Private letter rulings issued by the IRS confirm that the foreign taxes paid by a partnership, at least in the circumstances addressed by those rulings, "flow through" to its partners (P.L.R. 7934096 and P.L.R. 7211160390A).

Subparagraph d) of point 8 of the Protocol clarifies that the Convention does not provide for a "tax sparing" credit, that is, a credit for taxes waived under a tax holiday or other provision. It is firm U.S. treaty policy not to grant a treaty credit for taxes that are not in fact paid to the treaty partner; the foreign tax credit in the United States is available only for taxes actually paid or accrued to a foreign taxing authority. Subparagraph d) does, however, provide that, in the event the United States revises this policy or agrees in a treaty with another country to give a tax sparing credit, this Convention will be promptly amended to incorporate a tax sparing credit. If this Convention is so amended, approval by the United States Senate would be required before a tax sparing credit would be effective with respect to Kazkkhstan.

24. NON-DISCRIMINATION

This Article ensures that citizens and residents of a Contracting State will not be subject to discriminatory taxation in the other Contracting State. This Article does not require identical treatment of taxpayers. Distinctions in tax treatment may be based upon differences in taxpayers' circumstances and in such cases are not discriminatory within the meaning of this Article. Certain examples of such treatment are discussed below.

Generally, non-discrimination under this Article 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 Kazakh 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 favorable regime will also apply to joint ventures in which the foreign participation is by 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 which are different from or more burdensome 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 Kazakhstan 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 Kazakhstan or a third country, is not in the same circumstances as a citizen of Kazakhstan who is a resident outside the United States, whether in Kazakhstan or a third country, because the U.S. citizen is subject to U.S. tax on his worldwide income and the Kazkahstan citizen is subject to U.S. tax only on his U.S. income. 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 Kazakh 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 7 (Associated Enterprises), paragraph 6 of Article 11 (Interest) or paragraph 6 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 involving related persons. Paragraph 3 is not intended to limit in any way the application of domestic thin capitalization rules, such as section 163(j), which may deny or defer deductions for interest, as long as such rules continue to be consistent with the arm's length standard. 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 local authorities in either Kazakhstan or 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 which 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 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 which impose tax on a liquidating distribution of a U.S. subsidiary of a Kazakh 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 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) or the branch level interest tax described in paragraph 7 of Article 11 (Interest).

Paragraph 6 provides that, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered), the non-discrimination protection in 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 language 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 Kazakhstan may claim benefits in the United States under this Article.

Article 25. 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 for the purpose of imposing 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 (Associated Enterprises). 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.

Paragraph 5 provides for an arbitration procedure, to be implemented subsequently by an exchange of diplomatic notes. 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 provisions of the U.S.-Germany treaty, which entered into force in 1991 and which contains the first arbitration provision of any U.S. income tax treaty. If the competent authorities decide to exchange the diplomatic notes to implement an arbitration procedure in this Convention, they will also agree to procedures to be followed in arbitration. It is expected that such procedures will ensure that arbitration will not generally be available where matters of either State's tax policy or domestic law are involved, that the arbitrators will be bound by the Convention's confidentiality and disclosure provisions, and that the decision in arbitration will be premised upon the Convention, the provisions of each State's domestic law, and the principles of international law. The procedures to be established by the exchange of notes also will address the costs of arbitration and the composition of the arbitration board.

Point 9 of the Protocol also provides for the competent authorities to consult whenever either believes that the law of the other Contracting State is or may be applied in a manner that significantly limits or eliminates a benefit provided by the Convention. In that event, the competent authorities shall consult with a view to restoring the balance of benefits. The State of which the request to consult is made shall accede to the 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 29 (Termination) even if the Convention has been in force fewer than five years. Alternatively, the affected State may resort to other procedures permitted under the general principles of international law.

This Article 25 represents another exception to the saving clause of paragraph 3 of Article 1 (General Scope); the benefits of this Article are thus available to residents of either Contracting State and to U.S. citizens. (See paragraph 4(a) of Article 1.)

Article 26. 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 Kazakhstan 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 (see paragraph 4). 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 for purposes of implementing the taxes covered by Article 2, 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 Kazakhstan 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 which it is not obligated to provide under the provisions of this paragraph.

The Memorandum of Understanding between the two States clarifies that, notwithstanding any provision of either State's law, information contained in banking documents, including banking documents pertaining to third persons involved in transactions with residents of either State, will be made available under this Article, in civil or criminal tax investigations. Thus, domestic laws regarding bank secrecy may not be invoked to prevent the exchange of banking information or documents under this Article.

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 27. 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. Thus Article protects any fiscal privileges of technical staff and other employees of such missions as well as those with diplomatic status.

Article 28. 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 July 1, 1995, the withholding rates on dividends, interest and royalties would be reduced (or eliminated) for amounts paid on or after September 1, 1995. For all other income taxes, the Convention will have effect for taxable periods beginning on or after January 1 of the year in which the Convention enters into force.

The 1973 Convention will cease to have effect when the provisions of this Convention take effect. Point 10 of the Protocol provides that a person entitled to the benefits of the Convention may elect to continue to apply any legal rules under the 1973 Convention for the first taxable year in which this Convention would otherwise have effect. This is a taxpayer-by-taxpayer election. This provision can be relevant, for example, 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 legal rules applicable under the 1973 Convention for the first taxable year, but he could not choose, for example, to apply the 1973 Convention rules with respect to personal service income and the rules of this

Convention with respect to dividend income. A U.S. company that has already begun to perform a construction contract or to explore for oil in Kazakhstan might also elect to apply the rules of the 1973 Convention because that Convention contains a more generous permanent establishment threshold (36 months) than does the proposed Convention (12 months). (However, the maximum benefit that such a company could obtain from the 1973 Convention is 12 additional months.)

Article 29. 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, because the notice period must continue for at least six months.

Article 29 relates to unilateral termination of the Convention by a Contracting State. 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.

Point 9 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 29. This provision, discussed in more detail in the explanation of Article 25 (Mutual Agreement Procedure), above, was included at the request of Kazakhstan to address the possibility of future U.S. legislative provisions overriding one or more treaty provisions.

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.

MEMORANDUM OF UNDERSTANDING

The Memorandum of Understanding reflects the Contracting States' mutual interpretation of certain Convention provisions and is equally binding on both States. Its provisions have been described in the discussion of the articles to which they refer.

TREASURY DEPARTMENT
TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF SWEDEN FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME SIGNED AT STOCKHOLM ON SEPTEMBER 1, 1994

INTRODUCTION

This document is a technical explanation of the Convention between the United States and Sweden signed on September 1, 1994 ("the Convention"). References are made to the Convention between the United States and Sweden for the avoidance of double taxation and the establishment of rules of reciprocal administrative assistance in the case of income and other taxes signed on March 23, 1939, as amended by the Supplementary Protocol signed on October 22, 1963 ("the prior Convention"). The Convention replaces the prior Convention. References in this Explanation to the "OECD Model" are to the Model Tax Convention on Income and on Capital, published by the OECD in 1992, as amended in 1994.

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 Convention was accompanied by an exchange of notes dealing with two provisions of the Convention. These notes will be discussed in the explanations of the relevant Articles.

Article 1. PERSONAL SCOPE

Paragraph 1 provides that the Convention is applicable to residents of the United States or Sweden except where the terms of the Convention provide otherwise. Under Article 4 (Residence) 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, paragraph 1 of Article 24 (Non-discrimination) applies to citizens of the Contracting States, irrespective of their residence. Under Article 26 (Exchange of information) information may be exchanged with respect to residents of third States.

Paragraph 2 of Article 1, like the comparable provision of other U.S. treaties, 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 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 Sweden, the deduction will be available to that person in computing income under the Convention. In no event may the application of 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 Sweden 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 Sweden. 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.

Paragraph 3 of Article 1 affects obligations undertaken by the Contracting States under other agreements. Subparagraph (a) provides that, notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning whether a

measure is within the scope of this Convention shall be considered only by the competent authorities of the Contracting States, and the procedures under this Convention exclusively shall apply to the dispute. Thus, procedures for dealing with disputes that may be incorporated into trade, investment, or other agreements between the Contracting States shall not apply for the purpose of determine the scope of the Convention.

Subparagraph (b) of paragraph 3 provides that, unless the competent authorities determine that a taxation measure is not within the scope of this Convention, the nondiscrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favored-nation ("MFN") obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade ("GATT"). No national treatment or MFN obligation under any other agreement shall apply with respect to that measure. Thus, unless the competent authorities agree otherwise, any national treatment and MFN obligations undertaken by the Contracting States under agreements other than the Convention shall not apply to a taxation measure with the exception of GATT as applicable to trade in goods.

Subparagraph(c) of paragraph 3 defines a "measure" as a law, regulation, rule, procedure, decision, administrative action, or any other form of measure.

The provisions of paragraph 3 are an exception to the rule provided in paragraph 2 of this Article under which the Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by any other agreement between the Contracting States.

Paragraph 4 contains the traditional saving clause, and paragraph 5 contains exceptions. In many U.S. treaties the provision is reciprocal. Sweden, however, was not interested in preserving its taxing right over Swedish citizens and residents, so the provision was made unilateral, affecting only U.S. taxing rights. Under paragraph 4 the United States reserve its right, except as provided in paragraph 5, to tax its residents and citizens notwithstanding any Convention provisions to the contrary. The concept of "residence" for purposes of the Convention, including the saving clause, is defined in Article 4 (Residence). The saving clause operates as follows: If, for example, a Swedish 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 Swedish 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 Sweden see paragraph 3 of Article 23 (Relief from double taxation)). If 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 Sweden under Swedish law, and that individual has a permanent home available to him in Sweden and not in the United States, he would be treated as a resident of Sweden 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 4, the United States reserves its right to tax former U.S. citizens whose loss of citizenship had as one of its principal purposes the avoidance of U.S. 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.

Paragraph 5 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 U.S. benefits to its citizens and residents. Subparagraph 5(a) lists certain provisions of the Convention that will be applicable to all U.S. citizens and residents, despite the general saving clause rule of paragraph 4: (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 2 of Article 19 (Pensions and annuities) deals with social security benefits. Its inclusion in the exceptions to the saving clause means that social security benefits paid by Sweden to a U.S. resident will, as intended, be taxed only by Sweden. (3) Article 23 (Relief from double taxation) confers the benefit of double taxation relief by a Contracting State on its citizens and residents. To apply the saving clause to this Article would render the Article meaningless. (4) Article 24 (Non-discrimination) generally prohibits discriminatory taxation by one Contracting State of 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 25 (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 or the competent authorities may use a definition of a term which differs from the internal law definition. As with the foreign tax credit, these benefits are intended to be granted by a State to its citizens and residents.

Subparagraph 5(b) provides a different set of exceptions to the saving clause. The effect of this provision is to extend certain benefits to persons who are neither U.S. citizens nor lawful permanent residents (i.e., "green card" holders). If, for example, beneficiaries of these provisions come to the United States from Sweden 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 United States citizens, 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 students and trainees under Article 21 (Students and trainees); and the income of diplomatic and consular officers under Article 28 (Diplomatic agents and consular officers).

Article 2. TAXES COVERED

This Article identifies the U.S. and Swedish taxes to which the Convention applies. The covered taxes of the United States are specified in subparagraph 1(a). They are the Federal income taxes imposed by the Code (excluding the accumulated earnings tax and the personal holding company tax), the excise taxes imposed on insurance premiums paid to foreign insurers (Code section 4371), and the excise taxes imposed with respect to private foundations (Code sections 4940 through 4948). The Convention does not apply to social security taxes (Code sections 1401, 3101, 3111 and 3301). U.S. and Swedish social security taxes are dealt with in the bilateral Social Security Totalization Agreement, which entered into force on January 1, 1987.

The Convention applies to the U.S. 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 which the United States is a party) to exemption from the tax. Providing Convention coverage for the U.S. insurance excise tax effectively exempts from the tax Swedish companies that insure U.S. risks, subject to the anti-conduit rule for reinsurance described above. This result is confirmed in paragraph 8 of Article 7 (Business profits). Under the Code, the tax applies to a Swedish company only if it earns premiums that are not attributable to an active trade or business in the United States or that are exempt by treaty from net basis U.S. income tax (because they are not attributable to a permanent establishment). Under Article 7 (Business profits), the United States does not subject the business profits of a Swedish enterprise to 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 Swedish insurers if such premiums were not attributable to a permanent establishment of the insurer in the United States.

Except with respect to Article 24 (Non-discrimination), state and local taxes in the United States are not covered by the Convention. Article 24 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.

Sub-paragraph 1(b) specifies the existing Swedish taxes to which the Convention applies. These are: (i) the State income tax, including the sailor's tax and the coupon tax; (ii) the special income tax on non-residents; (iii) the special income tax on non-resident entertainers and artistes; (iv) the communal income tax; (v) the State capital tax; and (vi) the excise tax imposed on insurance premiums paid to foreign insurers. The State capital tax is covered only as described in paragraph 3 of the Article (see below).

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 1, 1994 (the date of signature of the Convention). The paragraph further provides that the U.S. and Swedish 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. It also provides that the competent authorities notify each other of any significant published materials dealing with the Convention. Such materials include official explanations, regulations, rulings or judicial decisions.

Paragraph 3 provides rules that limit the extent to which the Swedish State capital tax will apply under the Convention to certain classes of U.S. citizens and residents (as determined under Article 4 (Residence)). The base of the tax applicable to those persons (described below) is limited to real property situated in Sweden and to movable property attributable to a Swedish permanent establishment of the U.S. taxpayer or to a fixed base available to the taxpayer in Sweden for the purpose of performing independent personal services. Thus, such persons will not be subject to the Swedish capital tax on non-Swedish property. The persons subject to the tax only on this limited basis are specified in subparagraphs (a) through (e) of paragraph 3. They are: (a) an individual who is both a citizen and resident of the United States, and who is not a citizen of Sweden; (b) an individual U.S. resident, regardless of his citizenship, who has been a U.S. resident for three successive taxable years prior to the effective date of the Convention (i.e., the first year beginning after the exchange of instruments of ratification) and for each taxable year thereafter; (c) a U.S. citizen who is not also a Swedish citizen, and who visits Sweden for a period not exceeding two years, and who is, or was immediately prior to such visit, a resident of the United States; (d) the estate of any of the individuals described in the three preceding subparagraphs; and (e) any company resident in the United States.

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 other terms 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.

Subparagraph 1(a) defines the term "person" to include an individual, an estate, a trust, a partnership, a company and any other body of persons. The term "company" is defined in subparagraph 1(b) as 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 terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" are defined in subparagraph 1(c) as an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State, respectively. The term "enterprise" is not defined in the Convention.

Subparagraph 1(d) 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 15 (Dependent personal services). The term means any transport by a ship or aircraft except when the vessel is operating solely between places within a Contracting 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 Swedish 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 Swedish 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 not apply under the circumstances described. If, however, goods or passengers are carried from Stockholm 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(e)(i) and (ii) define the term "competent authority" for the United States and Sweden, respectively. 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. The competent authority of Sweden is the Minister of Finance, his authorized representative, or the authority which is designated as competent authority for the purposes of the Convention.

The terms "United States" and "Sweden" are defined in subparagraphs 1(f) and (g), respectively. 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. 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. The term "Sweden" means the Kingdom of Sweden. The term includes the Swedish continental shelf (with respect to the exploration or exploitation of natural resources).

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 25 (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 - RESIDENCE

Article 4 sets forth rules for determining whether a person is a resident of the United States or Sweden for purposes of the Convention. 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 (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 assigns 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 a Contracting State." In general, this definition incorporates the definitions of residence in U.S. and Swedish law. A resident of a Contracting State is a person who, under the laws of that State, is subject to tax there by reason of his domicile, residence, place of management, place of incorporation or any other criterion of a similar nature. Nontaxable entities are considered residents of their state of organization because they are subject to the taxation laws of that state. Residents of the United States include aliens who are considered U.S. residents under Code section 7701(b). Unlike certain other U.S. treaties, "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.

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 Swedish 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 Swedish 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 a partnership, 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, a partnership, 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 partner, grantor, the beneficiaries or the partnership, 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.

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 the United States (or a citizen of the United States) to be treated as a United States resident under the Convention. A United States citizen or an alien lawfully admitted for permanent residence (a "green card holder") who does not have a substantial presence, permanent home, or habitual abode in the United States and who is not a resident of Sweden under paragraph 1, will not be treated as a resident of the United States for purposes of the Convention. Thus, a U.S. citizen or green card holder who is resident in a third country and who has a substantial presence, permanent home or habitual abode in the United States will be entitled to most benefits under the Convention. If such a person is also considered a resident of Sweden under Swedish internal law, and therefore under paragraph 1, the individual will be considered a resident of both States. Such person's status will be determined under the tie-breaker rules of paragraph 2 (described below).

If an individual is considered a resident of each State under its laws, 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 "center of vital interests." Under paragraph 2(b), if he has no center 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 citizen. If he is a citizen of both States or of neither, paragraph 2(d) provides that the competent authorities will, by mutual agreement, assign a single State of residence.

Paragraph 3 addresses companies that are treated by each State, under its laws, as a resident of that State. Paragraph 3 provides that if a company is considered under paragraph 1 to be a resident of both States, then if it is created under the laws of either the United States or Sweden it will be considered to be a resident of the state in which it is created.

Paragraph 4 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.

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 14 (Independent personal services) is understood by reference to the definition of "permanent establishment," this Article is also relevant for purposes of Article 14. 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.

This Article follows closely both the OECD Model provisions and recent U.S. treaties. The protocol to the prior Convention contains a similar definition of "permanent establishment".

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 illustrative 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, oil or gas well, 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.

In addition, installations, drilling rigs, or ships operating offshore to explore for or exploit natural resources are considered permanent establishments only if their use exceeds twelve months. Supply ships are not considered ships used to explore for or exploit natural resources. Natural resources do not include fish.

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 the purchases goods or merchandise, or for activities that have a preparatory or auxiliary character for the enterprise, such as advertising or the supply of information and 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.

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, which 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 of Article 6 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, is more limited than the expansive definition of "real property situated in the Other Contracting State" in paragraph 2 of Article 13 (Gains), which includes not only real property itself, but certain interests in real property.

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 14 (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 or fixed base in the situs State.

The Article does not include language found in many U.S. treaties providing for a taxpayer election to be taxed on real property income on a net basis. It was thought unnecessary to include such a provision since both States allow for net basis taxation of real property income under internal law.

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 is broadly similar to the rule in the prior Convention.

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 Swedish 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) is not applicable under the Convention.

Paragraph 2 differs in one respect from the comparable paragraph in many recent U.S. treaties, but conforms in this respect to the OECD Model. In certain other U.S. treaties, 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 language in other U.S. treaties 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, i.e., one that deals independently with all related companies, not just its home office. In the course of the negotiations, the Swedish negotiators made clear that they subscribed to the interpretation in the OECD Commentaries, but preferred to retain, at least in part, the language from the OECD Model. Thus, there should be no difference in application between paragraph 2 of Article 7 and its analogue in other U.S. treaties.

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 a reasonable allocation of expenses for research and development, interest and other similar expenses. Also included is a reasonable allocation of executive and general administrative expenses.

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.

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 11 (Interest), and not by Article 7, unless, 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.

Paragraph 7 provides a definition of "profits." The term is defined to mean income derived from any trade or business carried on by any person or group of persons. With one exception, the definition of business profits used in many U.S. treaties is retained in paragraph 7, including specifically the reference to income from the rental of tangible personal (movable) property. The definition does not, however, define film rentals as profits. Instead, film rentals are considered royalties under paragraph 2 of Article 12 (Royalties). There is little substantive significance in classifying film rentals under Article 12 instead of Article 7. Under both articles, film rentals are taxed exclusively by the residence country, unless they are attributable to a permanent establishment or a fixed base, in which case they may be taxed on a net basis in the country in which the permanent establishment or fixed base is located.

Paragraph 8 clarifies that the U.S. Federal excise tax on insurance or reinsurance premiums paid to foreign insurers will not be imposed on insurance premiums paid to an insurance business carried on by a Swedish enterprise, whether or not the business is carried on through a U.S. permanent establishment. The U.S. waiver of excise taxes applies only to the extent that the relevant risk is not reinsured, directly or indirectly, with a person not entitled to relief from such tax. Reinsurance of a relevant risk includes reinsurance against, or with respect to, underlying hazards, risks, losses, or liabilities within the United States. For example, the waiver would not be available if an underlying U.S. risk were reinsured or retroceded by a Swedish insurer to a Swiss insurer, because the U.S.-Switzerland income tax convention does not provide for a waiver of these U.S. excise taxes. Paragraph 8(b) states the corresponding rule for Swedish excise taxes on insurance premiums. Sweden does not impose an excise tax on reinsurance premiums.

The U.S. negotiators agreed to waive these excise taxes only after a review of Swedish law indicated that the income tax imposed by Sweden on Swedish resident insurers results in a burden that is substantial in relation to the U.S. tax on U.S. resident insurers. On the basis of this analysis, U.S. negotiators concluded that it was appropriate to waive the U.S. excise taxes in this Convention.

The waiver of the U.S. excise tax in paragraph 8 merely restates the result that obtains under a combination of U.S. law and other provisions of the Convention. The United States may not, pursuant to the provisions of paragraph 1 of Article 7, impose the excise tax on the income of any Swedish 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 (unless that amount is exempt from net basis U.S. income tax pursuant to a treaty obligation of 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 Swedish enterprise that is attributable to a permanent establishment in the United States.

Paragraph 9 clarifies 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).

This Article is subject to the saving clause of paragraph 3 of Article 1 (Personal scope). Thus, if, for example, a citizen of the United States who is a resident of Sweden 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 23 (Relief from 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 Swedish 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 17 (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(d) of Article 3 (General definitions). It is understood, based on the provisions of paragraph 2 of Article 1 (Personal 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 Sweden (effective on January 1, 1987) under the authority of Code section 883 (if any), will continue to be available regardless of any provisions to the contrary in the Convention.

Paragraph 1 provides that 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. 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 exemption under the Article to certain income from the bare-boat leasing of ships and aircraft. Unlike certain other U.S. treaties, 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 provides that the profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers (including equipment for their transport) which are used for the transport of goods in international traffic will be exempt from tax in the other Contracting State. This result obtains regardless of whether the recipient of the income is engaged in the operation of ships or aircraft in international traffic, and regardless of whether the enterprise has a permanent establishment in the other Contracting State. The shipping and air transport provisions of the prior treaty do not deal with income from the use, maintenance or rental of containers. Such income, therefore, is treated under that Convention as business profits.

Paragraph 4 clarifies that paragraphs 1 and 3 apply equally to profits from an enterprise of a Contracting State from participation in a pool, joint business or international operating agency. Profits derived by the air transport consortium Scandinavian Airlines System (SAS) are covered by paragraphs 1 and 3, but only to the extent that the SAS profits correspond to the participation held in that consortium by AB Aerotransport (ABA), the Swedish partner of SAS. SAS is an entity in the nature of a partnership which was created jointly by the legislatures of Sweden, Norway and Denmark. The exemption applies to the income of the consortium in its entirety because, in addition to the present Convention, the United States income tax conventions with Norway and Denmark provide similar exemptions to residents of those States.

In addition, notes exchanged at the signing of the convention provide that all income earned by SANA Inc. (Scandinavian Airlines of North America Inc., a New York corporation) from the operation in international traffic of aircraft would be treated as income of SAS, the consortium whose constituent corporate members own the stock of SANA Inc. SANA Inc. was created and is operated as an entity apart from SAS to satisfy U.S. regulations regarding foreign airlines, which SAS as a consortium could not meet. SANA Inc. is a conduit for SAS with regard to receipts and its expenses are guaranteed by SAS. Therefore the income of SANA Inc. will be taxed no differently under the Convention than if it were earned directly by SAS.

The taxation of gains from the alienation of ships, aircraft or containers is dealt with in paragraph 4 of Article 13 (Gains).

This Article is subject to the saving clause of paragraph 4 of Article 1 (Personal scope). The United States, therefore, may, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from double taxation), tax the shipping or air transport profits of a resident of Sweden if that Swedish resident is a citizen of the United States.

As with any benefit of the Convention, an enterprise claiming the benefit of this Article must be entitled to the benefit under the provisions of Article 17 (Limitation on benefits).

Article 9 - ASSOCIATED ENTERPRISES

Article 9 incorporates into the Convention the general principles of Code section 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 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 Swedish corporation as having made a distribution of profits to its U.S. parent corporation, the provisions of Article 10 (Dividends) will apply, and Sweden may impose a withholding tax on the dividend. The rate of the tax will be determined by the provisions of Article 10. 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.

Paragraph 3 clarifies that nothing in this Article affects 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.

If a correlative adjustment is made under paragraph 2, it is to be implemented pursuant to paragraph 2 of Article 25 (Mutual agreement procedure), notwithstanding any time limits or other procedural limitations in the law of the Contracting State making the adjustment. The saving clause of paragraph 4 of Article 1 (Personal scope) does not apply to paragraph 2 of Article 9 (see the exceptions to the saving clause in subparagraph (a) of paragraph 5 of Article 1). 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 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 the residence country to tax its residents on dividends received from a company that is a resident of the source country.

Paragraph 2 grants the source country the right to tax dividends paid by a company that is a resident of the source country. If the beneficial owner of the dividends is a resident of the other Contracting State, the source country tax is limited to 5 percent of the gross amount of the dividends if the beneficial owner is a company that holds directly at least 10 percent of the

voting power of the company paying the dividends. Source country taxation is limited to 15 percent of the gross amount of the dividends 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. Paragraph 3 provides special rules for certain U.S. conduit entities. 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.

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 attributable 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.

This paragraph does not affect the taxation of the profits out of which the dividends are paid, but affects the taxation only of the dividend itself.

Special limitations on the rate of source country taxation are also provided in paragraph 3 for dividends paid by U.S. Regulated Investment Companies and Real Estate Investment Trusts ("RICs" and "REITs"). Dividends paid by RICs 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 Swedish corporate recipient of the dividend. Dividends paid by a REIT are generally taxed at source at the full 30 percent statutory rate. However, dividends paid by REITs are taxed at source at the 15 percent portfolio dividend rate if the beneficial owner of the dividend is a Swedish individual who owns less than a 10 percent interest in the REIT.

The denial of the 5 percent withholding rate at source to all RIC and REIT shareholders, and the denial of the 15 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, a Swedish 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 Swedish corporation owns more than 10 percent 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 Swedish 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 at source by the United States at only 5 percent.

Similarly, a resident of Sweden may hold U.S. real property directly, and pay U.S. tax either at a 30 percent rate on gross income or at the ordinary income tax 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 Swedish investor could transform real estate income into dividend income, and absent the special rule, transform high-taxed income into much lower-taxed income. In the absence of the special rule, if the REIT shareholder is a Swedish 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, a tax of 30 percent or more would be significantly reduced. One exception to this rule 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 3, such individuals, defined as those holding less than a 10 percent interest in the REIT, remain taxable at source at a 15 percent rate.

Paragraph 4 defines the term dividends as used in the Convention. The term includes income from shares or other rights (not being debt-claims) 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. The term also includes income from arrangements (including debt obligations) that carry the right to participate in profits to the extent so characterized under the laws of the Contracting State in which the income arises.

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 14 (Independent personal services) of the Convention.

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.

Paragraph 7 provides an exemption from U.S. excise taxes on private foundations in the case of a religious, scientific, literary, educational, or charitable organization which is resident in Sweden, but only if such organization has received substantially all of its support from persons other than citizens or residents of the United States. This provision is designed to ensure that the Nobel Foundation, a Swedish charitable organization, will not be subject to U.S. excise taxes. This provision is similar to paragraph 4 of Article XXI of the income tax treaty between the United States and Canada.

Paragraph 8 provides for the imposition of a branch profits tax. This paragraph 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 13 (Gains). In the case of the United States, the base to which the tax is applied includes only 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 13. This amount is only subject to the branch profits tax to the extent that it represents 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 8.

For example, the United States may impose its branch profits tax on business profits of a Swedish 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 Swedish corporation subject to taxation on a net basis because the Swedish 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 Swedish 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 13.

Although paragraph 8 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 9 provides that the branch profits tax permitted by paragraph 8 shall not be imposed at a rate exceeding the direct dividend withholding rate of five percent that is provided for in paragraph 2(a).

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of paragraph 4 of Article 1 (Personal scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from 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 17 (Limitation on benefits).

Article 11 - INTEREST

Article 11 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.

Unlike the prior Convention which did not explicitly define "interest", under the new treaty, paragraph 2 of Article 11 expansively defines the term "interest" as used in this Article to mean income from debt-claims of every kind, whether or not the claim is secured by a mortgage, and whether or not carrying a right to participate in the profits of the debtor. The definition of interest includes income from Government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds or debentures. The definition also encompasses 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. Interest does not include dividends as defined in Article 10 even if such dividends are income arising from debt-claims.

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 14 (Independent personal services) will apply and the source State will generally retain the right to impose tax on such interest income.

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 is borne by that permanent establishment or fixed base. In that case, the interest is deemed to arise in the State in which the permanent establishment or fixed base is situated.

Paragraph 5 deals with cases where there is a special relationship between the payer and the beneficial owner of interest. The provisions of Article 11 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 Sweden 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, under subparagraph (a), the United States may tax interest paid by a Swedish resident to a resident of the United States as part of the world-wide income of the U.S. resident. Under subparagraph (b), the United States may tax interest paid by a resident of Sweden if that interest is attributable to a permanent establishment located in the United States, and is therefore subject to U.S. tax as part of the income of the permanent establishment. Finally, under subparagraph (c), the United States may tax interest paid by a resident of Sweden if (1) that interest is borne by a U.S. permanent establishment of that Swedish resident, (2) it is not portfolio interest or otherwise exempt from U.S. tax, and (3) the beneficial owner of the interest is a resident of a country that does not have a treaty

with the United States that exempts interest from tax at source. For example, if a U.S. permanent establishment of a Swedish company borrows from a Swiss bank, interest paid on that loan would be U.S. source, and would be subject to tax at a rate of 5 percent under the U.S.-Switzerland treaty. No tax, however, would be imposed by the United States on the permanent establishment of the Swedish company under the excess interest provisions of section 884(f) of the Code, since excess interest is treated in this case as interest paid by a resident of the United States to a resident of Sweden, and such interest is exempt from U.S. tax under paragraph 1 of this Article.

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. Instead, such income may be taxed in the State where the excess inclusion arises. Under United States law, 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 Sweden to Congressional intent.

Notwithstanding the limitations on source country taxation of interest contained in this Article, the saving clause of paragraph 4 of Article 1 (Personal scope) permits the United States to tax interest received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from 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 17 (Limitation on benefits).

Article 12 - ROYALTIES

Article 12 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.

Paragraph 2 generally follows other U.S. treaties 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, trade mark, 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. In addition, 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 included in the definition of royalties. 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 inclusion of payments relating to the use of such means of reproduction within the definition of royalties.

Paragraph 3 of Article 12 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 14 (Independent personal services) will apply, and the source state will generally retain the right to tax such royalties on a net basis.

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 12 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).

Notwithstanding the limitations on source country taxation of royalties contained in this Article, the saving clause of paragraph 4 of Article 1 (Personal scope) permits the United States to tax royalties received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from 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 17 (Limitation on benefits).

ARTICLE 13 - GAINS

Article 13 provides rules for source and residence country taxation of gains from the alienation of property.

Paragraph 1 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. However, paragraph 1 does not grant the situs State an exclusive right to tax these gains. The residence State may also tax these gains from real property, subject to the rules of Article 23 (Relief from double taxation).

Paragraph 2 defines the term "real property situated in the other Contracting State." Where the United States is the source State, the term includes real property referred to in Article 6 (Income from real property) and certain indirect interests in such property. Such indirect interests include a United States real property interest in the United States, as that term is defined in the Code on the date of signature of the Convention, and as amended. In addition, the treaty clarifies that an interest in a partnership, trust, or estate, to the extent that the assets of such entity consist of United States real property interests situated in the United States, are included in this definition. 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(g). 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.

Where Sweden is the source state, the term "real property situated in the other Contracting State" includes property that is real property under the laws of Sweden that is situated in Sweden. This encompasses real property referred to in Article 6 and shares or similar rights in a company the assets of which consist, directly or indirectly, mainly of such real property.

The definition of "real property situated in the other State" applies solely for purposes of Article 13. Therefore, this definition has no effect on the right to tax income covered in other articles of the Convention, such as Article 6 (Income from real property).

Paragraph 3 preserves the source country right to tax gains from the disposition of movable property in certain circumstances. Paragraph 3 provides that gains from the disposition of movable property which are attributable to a permanent establishment which an enterprise of a State has in the other State or which are attributable to a fixed base available to a resident of a State for the purpose of performing independent personal services, and gains from the disposition of such a permanent establishment (alone or with the whole enterprise) or of such a 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, whether or not the assets of such partnership consist of movable property.

The rule in paragraph 9 of Article 7 (Business profits) dealing with deferred income and expenses of a permanent establishment or fixed base applies to paragraph 3 of this Article. Thus, gains from the disposition of movable property which are attributable to a permanent establishment or fixed base, but are 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 further exception from the rule set forth in paragraph 3. Paragraph 4 provides that profits derived from the disposition of ships and aircraft operated by an enterprise in international traffic and from movable property (such as containers) attributable to the operation of such ships and aircraft are taxable only in the State in which the enterprise is resident. This paragraph applies to gains derived by the air transport consortium Scandinavian Airlines System ("SAS"), but only to the gains that correspond to the participation held in that consortium by AB Aerotransport ("ABA"), the Swedish partner of SAS. (The special status of SAS is discussed in connection with Article 8 (Shipping and air transport).)

Even though the issue is addressed in the first sentence of the paragraph, the second sentence of paragraph 4 explicitly clarifies that gains from the disposition of containers used in international traffic by an enterprise of a Contracting State shall be taxable only in that State. For this purpose, containers are deemed to include trailers, barges, and related equipment used for the transport of containers.

Paragraph 5 provides that gains described in Article 12 (Royalties) shall be taxable in accordance with the provisions of Article 12. 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 or disposition thereof, which are described in paragraph 2 of Article 12. Treatment of gains attributable to intangible property that are not described in paragraph 2 of Article 12 is governed by paragraphs 3 or 6 of Article 13.

Subject to the special rule of paragraph 7, paragraph 6 grants to the residence State the exclusive right to tax gains from the disposition of property other than those specifically referred to in the preceding paragraphs of Article 13.

Paragraph 7 provides a special rule for an individual who had been a resident of Sweden and who has become a resident of the United States. With respect to such an individual, Sweden will have the right to tax gains referred to in paragraph 6 from any property derived by such individual at any time during the ten years following the date on which the individual ceased to be a resident of Sweden. Although this Article is not reciprocal, pursuant to paragraph 4 of Article 4 (Residence) the United States retains the right to tax its former citizens where their loss of citizenship had as one of its principal purposes the avoidance of tax.

Notwithstanding the foregoing limitations on source country taxation of certain gains, the saving clause of paragraph 4 of Article 1 (Personal scope) permits the United States to tax gains realized by its residents and citizens, subject to the special foreign tax credit rules of Article 23 (Relief from 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 17 (Limitation on benefits).

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 dependent personal service income. Exceptions or additions to these general rules are found in Articles 16 and 18 through 21 for directors' fees (Article 16); performance income of artistes and athletes (Article 18); pensions in respect of personal service income, social security benefits, and annuities (Article 19); government service salaries and pensions (Article 20); and students and trainees (Article 21).

Article 14 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 performed in that other State, 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 Swedish 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 4 of Article 1 (Personal scope), tax his income without regard to the restrictions of this Article, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (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," 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 14 the income of a resident of one Contracting State must be attributable to a permanent establishment or fixed base in the other State in order for that other State to have a taxing right. In Article 14, however, the income also must be attributable to services that are performed in that other State, 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.

The rule in paragraph 9 of Article 7 (Business profits) dealing with deferred income and expenses of a permanent establishment or fixed base applies to 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.

Article 15 - DEPENDENT PERSONAL SERVICES

Article 15 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 23 (Relief from 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 16 (Directors' fees), 19 (Pensions and annuities), and 20 (Government service) is governed by the provisions of those articles rather than this Article.

Paragraph 2 provides that the host State may not tax the remuneration of a resident of the other State derived from services performed in the host State, if three conditions are satisfied: (1) the individual is present in the host State for a period or periods not exceeding 183 days in any consecutive twelve month period; (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, including an aircraft operated in international traffic by the air transport consortium Scandinavian Airlines System ("SAS"). (The special situation of SAS is discussed in connection with Article 8 (Shipping and air transport).) Such remuneration shall be taxable 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. However, services performed by an individual as a member of a regular complement of a ship operated in international traffic by a Swedish enterprise may be taxed in Sweden.

The comparable provision in the OECD Model provides a different rule with respect to operations by a United States enterprise. 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 many other treaties, 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 Sweden performs dependent services in the United States and meets the conditions of paragraph 2, or is a crew member on a Swedish 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 4 of Article 1 (Personal scope), subject to the special foreign tax credit rule of paragraph 3 of Article 23 (Relief from double taxation).

Article 16 - DIRECTORS' FEES

This Article provides that one of the States may tax the fees 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 of the company. 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 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 country of residence of the corporation, whether the fee is attributable to a fixed base is not relevant.

This Article is subject to the saving clause of paragraph 4 of Article 1 (Personal scope). Thus, if a U.S. citizen who is a Swedish 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 3 of Article 23 (Relief from 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 17 - LIMITATION ON BENEFITS

Article 17 addresses the problem of "treaty shopping" by limiting the source basis tax benefits of the Convention to those residents of the other Contracting State that have a substantial nexus with, or otherwise have a significant business purpose for residing in, the other Contracting State. In a typical case of treaty shopping, 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 treaty benefits with respect to that income. Article 17 limits the abuse of the Convention by limiting the benefits of the Convention to those persons whose residence in a Contracting State is not considered to have been motivated by the existence of the Convention. Absent Article 17, the entity generally would be entitled to benefits under the treaty as a resident of a Contracting State, although the entity might be denied those benefits as a result of limitations (e.g., business purpose, substance-over-form, step transaction or conduit principles or other anti-avoidance rules) applicable to a particular transaction or arrangement. Article 17 and the general anti-abuse provisions complement each other, as Article 17 generally determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while general anti-abuse provisions determine whether a particular transaction should be recast in accordance with the substance of the transaction.

The structure of Article 17 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. Several of these, which will be discussed first, 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.

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, political subdivisions or local authorities thereof. It is most unlikely that persons falling into these two categories can be used to derive treaty benefitted income, as the beneficial owner of the 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 benefit, because of the requirements in those articles that the beneficial owner of the income be a resident of a Contracting State.

Subparagraph (d) provides a two-part test, the ownership and base erosion tests, both of which must be met 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 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) not more than 50 percent of the person's gross income is used, directly or indirectly, to make deductible payments to persons, other than persons who are themselves eligible for benefits under the other tests of paragraph 1 (other than subparagraph (c)), or to U.S. citizens. It is understood that the term "gross income" is to be interpreted as in 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, insurers and reinsurers) it is not enough merely to require substantial ownership of the entity by treaty country residents or their equivalent. In order to prevent treaty benefits from inuring to third-country residents, 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 Swedish-owned Swedish corporation to be reloaned to a resident of the United States that is related to the third-country resident. In the absence of a treaty between the United States and the third country, the interest if earned directly by the third-country resident would be subject to a 30 percent withholding tax in the United States. The U.S. source interest income of the Swedish corporation, however, would be exempt from U.S. withholding tax under Article 11 (Interest) of the Convention. While the Swedish corporation would be subject to Swedish corporation 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 Sweden and the third country, that interest is exempt from Swedish tax, the U.S. treaty benefit with respect to the U.S. source interest income will have flowed to the third-country resident.

Under subparagraph (e), 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 3 of the Article to mean, in the United States, the NASDAQ System and any stock exchange which is registered as a national securities exchange with the Securities and Exchange Commission, and, in Sweden, the Stockholm Stock Exchange (Stockholms Fondbörs). Paragraph 3 also provides that the competent authorities may, by mutual agreement, recognize additional exchanges for purposes of subparagraph 1(e).

Subparagraph (f) provides that a not-for-profit organization (including a pension fund and a private foundation) which 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. A pension fund 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 17. Thus, one need not determine that more than half of the beneficiaries of a Swedish pension plan are residents of Sweden in deciding whether the plan is entitled to U.S. treaty benefits in respect of its income so long as the Swedish corporation sponsoring the fund is entitled to benefits under Article 17, because, for example, it is publicly traded on the Stockholm Stock Exchange. If, however, the sponsoring organization is not entitled to benefits, the tests of subparagraph 1(f) must be met.

Subparagraph 1(c) of Article 17 provides a test for eligibility for benefits for residents of a Contracting State that are not qualifying persons under any of the other tests of this paragraph. This is the so-called "active trade or business" test. Unlike the other tests of paragraph 1, it 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 that activity. Under the active trade or business test, a resident of one State deriving an item of income from the other State is entitled to benefits with respect to that income if that person (or a person related to that person) is engaged in an active trade or business in the first-mentioned State and the income in question is derived in connection with, or is incidental to, that trade or business.

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 those investment activities are banking or insurance activities carried on by a bank or insurance company.

Income is considered derived "in connection" with an active trade or business in a Contracting State if, for example, the income-generating activity in that State is "upstream," "downstream," or parallel to that going on in the other State. Thus, if the U.S. activity consisted of selling the output of a Swedish manufacturer or providing inputs to the manufacturing process, or of selling in the United States the same sorts of products that were being sold by the Swedish trade or business in Sweden, the income generated by that activity would be treated as earned in connection with the Swedish trade or business. Income would be considered "incidental" to the Swedish trade or business if, for

example, it were interest income earned from the short-term investment of working capital of the Swedish resident in U.S. securities.

An item of income will be considered to be earned in connection with or to be incidental to an active trade or business in Sweden if the income is derived by the resident of Sweden claiming the benefits directly or indirectly through one or more other persons that are residents of the United States. Thus, for example, a Swedish resident could claim benefits with respect to an item of income earned by a U.S. operating subsidiary but derived by the Swedish resident indirectly through a U.S. holding company interposed between it and the operating subsidiary.

It is expected that, in order for an item of income to be considered derived in connection with an active trade or business under subparagraph 1(c), the business activity in the residence State will be substantial in relation to the income generating activity in the source State. For example, the trade or business in Sweden must be substantial in relation to the activity in the United States that gave rise to the income in respect of which treaty benefits are being claimed. Given the relative sizes of the U.S. and Swedish economies, it is not necessary that the Swedish trade or business be as large as the U.S. income-generating activity. The Swedish trade or business cannot, however, in terms of income, assets, or similar measures, be only a very small percentage of the size of the U.S. activity.

The substantiality requirement is intended to prevent certain types of treaty-shopping abuses. For example, a third-country resident may want to acquire a U.S. company that manufactures television sets for worldwide markets; however, since its country of residence has no tax treaty with the United States, any dividends generated by the investment would be subject to a U.S. withholding tax of 30 percent. Absent a substantiality test, the investor could set up a Swedish corporation that would operate a small outlet in Sweden to sell a few of the television sets manufactured by the U.S. company. That Swedish corporation would then acquire the U.S. manufacturer with capital provided by the third-country resident. It might be argued that the U.S. source income is generated from business activities in the United States related to the television sales activity of the Swedish parent and that the dividend income should be subject to U.S. tax at the 5 percent rate provided by Article 10 (Dividends). However, the substantiality test would not be met in this example, so the dividends would remain subject to withholding in the United States at a rate of 30 percent.

In general, it is expected that if a person qualifies for benefits under 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. Under subparagraph 1(c), however, the test is applied separately for each item of income.

It is intended that the provisions of subparagraph 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.

Paragraph 2 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.

Paragraph 2 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 2, 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.

For purposes of implementing paragraph 2, 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.

It is contemplated that under paragraph 2 the Competent Authority of the United States will grant treaty benefits to the Nobel Foundation, a Swedish charitable organization.

Paragraph 4 provides that the competent authorities of the United States and Sweden will consult together to develop a commonly agreed application of this Article. In accordance with Article 26 (Exchange of information), the competent authorities

will exchange information necessary to carry out this Article and to safeguard the application of domestic laws.

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 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 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 any twelve month period exceeds $6,000 (or its equivalent in Swedish kronor). The $6,000 includes expenses reimbursed to the individual or borne on his behalf. If the gross receipts exceed $6,000, 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 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 in accordance with Article 18. An entertainer or athlete who receives less than the $6,000 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 $5,500 of income for a 12 month period, 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 14.

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 12 (Royalties) or Article 14 (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 12, 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 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 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 the entertainer or athlete 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, assume that a circus owned by a U.S. corporation performs in Stockholm, and the Swedish promoters of the performance pay the circus, which, in turn, pays salaries to the clowns. The circus has no permanent establishment in Sweden. 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 Swedish tax. Whether the salaries of the clowns are subject to Swedish tax depends on whether they exceed the $6,000 threshold in paragraph 1, and, if not, whether they are taxable under Article 15 (Dependent personal services).

This exception to the paragraph 2 override of the Articles 7 and 14 protection of persons providing the services of entertainers and athletes for non-abusive cases is not found in the OECD Model. The OECD Model language applies to non-abusive situations, *i.e.*, where the performer does not participate in the profits of the person providing the services. Paragraph 2 of this Convention, however, applies only if the performer participates in the profits of the venture. Therefore, paragraph 2 does not apply unless the arrangement is a potentially abusive situation. The language of this paragraph is consistent with the U.S. reservation to paragraph 2 of the OECD Model.

This Article is subject to the provisions of the saving clause of paragraph 4 of Article 1 (Personal scope). Thus, if an entertainer or athlete who is resident in Sweden 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 23 (Relief from 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 AND ANNUITIES

Article 19 deals with the taxation of private (i.e., non-government) pensions, annuities, social security, and similar benefits.

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. 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 2 of Article 19.

The term "annuity" as used in this Article is defined in paragraph 3 to mean a stated sum paid periodically at stated times during life or during a specified or ascertainable number of years under an obligation to make the payment in return for adequate and full consideration other than services rendered or to be rendered.

Paragraph 2 provides that pensions (including the Swedish "allmän tilläggspension") and other payments made by one of the States under the provisions of its social security system or similar legislation 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 under the provisions of a social security system as described in this paragraph are covered by this rule, and not by the rule of paragraph 2 of Article 20 (Government service). "Similar legislation" is defined in paragraph 2 of the notes exchanged at the time of the signing of the Convention 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 Sweden to a U.S. citizen not resident in the United States will not be taxable by the United States.

Paragraph 4 permits a resident of Sweden or the United States who is not a national of that country to deduct contributions paid by or on behalf of that individual to a pension or other retirement arrangement that is established and maintained and recognized for tax purposes in the other country to the same extent that deductions would be permitted in the first-mentioned country. The contributions are only deductible, however, if the competent authority of the State permitting the deduction agrees that the pension scheme or other retirement arrangement of the other State generally corresponds to a pension scheme or other retirement arrangement recognized for that purpose in the first State. In either Contracting State, a pension or other retirement arrangement will qualify as "recognized for tax purposes" in that State if contributions to the arrangement would qualify for tax relief in that State.

Paragraph 2 is one of the exceptions listed in paragraph 5(a) of Article 1 (Personal scope) to the saving clause of paragraph 4 of that Article. Thus, the United States will not tax social security benefits paid by Sweden to a U.S. citizen who is a resident of Sweden. The provisions of this Article (except those of paragraph 2 dealing with social security benefits) are subject to the saving clause of paragraph 4 of Article 1 (Personal scope). Thus, for example, a periodic pension or annuity payment received by a resident of Sweden 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

Article 20 deals with the taxation of income (including pensions) from governmental employment.

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 citizen of that State or a person who did not become resident of that State solely for purposes of rendering the services. Thus, an individual who, after establishing U.S. residence, is hired by the Swedish Embassy in Washington, would be subject to U.S. (and not Swedish) tax on his Swedish salary.

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 citizen 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.

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 many U.S. treaties 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 14 (Independent personal services), 15 (Dependent personal services), 16 (Directors' fees), 18 (Artistes and athletes), and 19 (Pensions and annuities) 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 OECD Models which excludes payments in respect of services rendered in connection with a business carried on by the governmental entity paying the compensation or pension.

Under paragraph 5(b) of Article 1 (Personal scope), the saving clause (paragraph 4 of Article 1) 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 Swedish resident who receives a pension paid by Sweden in respect of services rendered to the Government of Sweden shall be taxable on this pension only in Sweden unless the individual is a U.S. citizen or acquires a U.S. green card.

Article 21 - STUDENTS AND TRAINEES

Article 21 deals with visiting students, apprentices, and business trainees.

An individual who is a resident of one of the Contracting States and who visits the other Contracting State for the purpose of full-time education or training, will not be taxed by that other State on amounts received from abroad to cover his expenses. The reference to "full-time" 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 laws of that State.

Under paragraph 5(b) of Article 1 (Personal scope), Article 21 is an exception to the saving clause of paragraph 4 of Article 1 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 - 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 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 14 (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 Sweden 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 Swedish 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 Sweden 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, 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 9 of Article 7 (Business profits) dealing with deferred income and expenses of a permanent establishment or fixed base applies to 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.

This Article is subject to the saving clause of paragraph 4 of Article 1 (Personal scope). Thus, the United States may tax the income of a Swedish resident not dealt with elsewhere in the Convention, if that Swedish resident is a citizen of the United States, subject, however, to the special foreign tax credit provisions of paragraph 3 of Article 23 (Relief from double taxation).

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 17 (Limitation on benefits).

Article 23 - RELIEF FROM DOUBLE TAXATION

Article 23 describes the manner in which each Contracting State undertakes to relieve double taxation. The United States uses the foreign tax credit method exclusively. Sweden uses a combination of foreign tax credit and exemption methods, depending on the nature of the income involved.

In paragraph 1, the United States agrees to allow to its citizens and residents a credit against U.S. tax for income taxes paid or accrued to Sweden. 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 of U.S. law at the time a credit is given.

Paragraph 1 also 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 Swedish 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 Swedish 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 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 Sweden.)

Paragraph 1 also provides that the Swedish income taxes specified in subparagraph 1(b) and paragraph 2 of Article 2 (Taxes covered) are to be treated as income taxes for purposes of allowing a credit under the Convention. However, the Swedish capital tax (specified in Article 2(1)(b)(v)) and the Swedish excise tax imposed on insurance premiums paid to foreign insurers (specified in Article 2(1)(b)(vi)) are not considered income taxes. It is not U.S. policy to allow credit by treaty for taxes which are not creditable under the Code, and it was the understanding of the negotiators that each of the Swedish income taxes for which credit is allowed under Article 23 are creditable taxes under the Code. If, however, it should be the case that a credit is being allowed under the Convention for a Swedish tax which is not a creditable income tax under the Code, the credit shall be limited on a per-country basis (*i.e.*, only allowed to offset net Swedish source income within the relevant foreign tax credit limitation category under Code section 904(a)).

Paragraph 2 of the Article provides the rules by which Sweden, in imposing tax on its residents, provides relief for U.S. taxes paid by those residents. Subparagraph 2(a) specified that where a resident of Sweden derives income which is subject to U.S. tax under this Convention (other than income taxed in accordance with the saving clause of Article 1(4)), Sweden will allow as a deduction from Swedish tax an amount equal to the income tax paid in the United States. The amount of this deduction is subject to the provisions of Swedish law, as it may be amended from time to time without changing the general principle of the Article (*i.e.*, the allowance of a credit). This paragraph also applies to Swedish taxation pursuant to Article 13(7) of certain individuals who had been residents of Sweden but who have become residents of the United States.

Under subparagraph 2(b), when a resident of Sweden earns income only taxable in the United States pursuant to paragraph 2 of Article 19 (Pensions and annuities) or Article 20 (Government service), Sweden may compute the exemption with progression. That is, in determining the rate of tax applicable under a progressive

rate structure to the income which is not exempt, Sweden may take the exempt income into account.

Subparagraph 2(c) specifies that dividends paid by a U.S. resident company to a Swedish resident company will be exempt from Swedish tax to the extent that the dividend would have been exempt under Swedish law if both companies had been Swedish companies (*e.g.*, the company receiving the dividends owns at least a 25 percent interest in the company paying the dividends). The exemption only applies if the profits out of which the U.S. resident paid the dividends have been subjected to normal U.S. corporate tax.

Paragraph 3 modifies the rules in paragraphs 1 and 2 for certain types of income derived from U.S. sources by U.S. citizens who are resident in Sweden. 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 Sweden will often exceed the U.S. tax allowable under the Convention on an item of U.S. source income derived by a resident of Sweden who is not a U.S. citizen.

Subparagraph 3(a) provides special Swedish tax rules for the taxation of U.S. citizens residing in Sweden. In this case, Sweden will allow as a deduction from Swedish tax U.S. income taxes paid on U.S. source income. The amount of this deduction is subject to the provisions of Swedish law, as it may be amended from time to time without changing the general principles thereof. In allowing the deduction, Sweden will not allow a bigger deduction than the amount of tax that would have been paid to the United States if the resident were not a U.S. citizen.

Subparagraph 3(b) deals with the potential for double taxation which can arise as a result of the absence of a full Swedish foreign tax credit, because of subparagraph 3(a), for the U.S. tax imposed on its citizens resident in Sweden. The subparagraph provides that the United States will credit the Swedish income tax paid, after allowance of the credit provided for in subparagraph 3(a). The credit allowed by the United States is subject to the limitations of the law of the United States, as it may be amended from time to time without changing the general principles hereof. It further provides that in allowing the credit, the United States will not reduce its tax below the amount which is allowed as a creditable tax in Sweden under subparagraph 3(a).

Since the income which is dealt with in paragraph 3 is U.S. source income, special rules are required to resource some of the income as Swedish source in order for the United States to be able to credit the Swedish tax. This resourcing is provided for in subparagraph 3(c), which deems the items of income referred to in subparagraph 3(a) to be from Swedish sources to the extent necessary to avoid double taxation under subparagraph 3(b).

Paragraph 4 provides rules to determine source of income to ensure that double tax is avoided under this Convention. The rules of this paragraph are subject to source rules in the domestic laws of the Contracting States. Paragraph 4 specifies two special source rules. First, income derived by a resident of a State is deemed to be from sources in the other State if it may be taxed by the other State in accordance with this Convention. This rule does not apply to income taxed by the other State exclusively by reason of citizenship (Article 1(4)) or former residency (Article 13(7)). Second, income derived by a resident of a State which may not be taxed under this Convention by the other State is deemed to be from sources in the first-mentioned State. Paragraph 4 does not apply in determining U.S. foreign tax credits for taxes other than the taxes referred to in paragraphs 1(b) and 2 of Article 2 (Taxes covered).

As specified in paragraph 5(a) of Article 1 (Personal scope), Article 23 is not subject to the saving clause of paragraph 4 of Article 1. 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 24 - NON-DISCRIMINATION

Article 24 assures that citizens of a Contracting State or entities deriving their status in a State (paragraph 1), and residents of a Contracting State (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 citizen of one of the States or a legal person, partnership or association deriving its status as such from the laws of one of the States may not be subject to taxation or connected requirements in the other Contracting State that are other or more burdensome than the taxes and connected requirements imposed upon a citizen or entity of that other Contracting State in the same circumstances. These persons are afforded protection under this paragraph even if they are not residents of either State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same treatment by Sweden as a Swedish citizen who is in similar circumstances (i.e., who is resident in a third country).

Paragraph 1 clarifies that this paragraph does not obligate the United States to apply the same taxing regime to a Swedish citizen who is not resident in the United States and a U.S. citizen who is not resident in the United States. Paragraph 1 applies only when the citizens 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 citizens of Sweden who are not United

States residents. Therefore, Article 24 would not entitle a Swedish citizen 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 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 in the first-mentioned State. This provision, however, does not obligate a Contracting State to grant to a resident of the other any personal allowances, reliefs, and other reductions for taxation purposes, that it grants to its own residents on account of their civil status or family responsibilities. Thus, if an individual resident in Sweden owns a Swedish 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 Swedish 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 Swedish 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 Swedish 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 Swedish partners, the requirement to withhold on the Swedish 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 overwithheld, the partner can, as in other cases of overwithholding, 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 5.)

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 11 (Interest) or paragraph 4 of Article 12 (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 11(5), relating to transactions not conducted in accordance with the arm's length standard. Paragraph 3 reflects the negotiators' understanding that Article 9 applies to issues relating to thin capitalization, and that adjustments to the 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 approach taken by section 163(j) is consistent with this description.

Paragraph 4 requires that a Contracting 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 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 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, 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 of the Article specifies that no provision of the Article will prevent either Contracting State from imposing the branch tax described in paragraph 8 of Article 10 (Dividends). Thus, even if the branch tax were judged to violate the provisions

of paragraphs 2 or 4 of the Article, neither Contracting 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 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 4 of Article 1 (Personal scope) does not apply to this Article, by virtue of the exceptions in subparagraph 5(a). Thus, a U.S. citizen who is resident in Sweden may claim benefits in the United States under this Article.

Article 25 - MUTUAL AGREEMENT PROCEDURE

Article 25 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 competent authorities of the two States are identified in subparagraph 1(e) 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 the State of which he is a resident or citizen. 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 (Personal 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 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).

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)).

Paragraph 3 also authorizes the competent authorities to consult for the purpose of eliminating double taxation in cases not provided for in 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 Sweden. 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 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 directly to reach agreements in the sense of this Article.

By virtue of the exceptions in paragraph 5(a) of Article 1 (Personal scope), this Article is not subject to the saving clause of paragraph 4 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 26 - EXCHANGE OF INFORMATION

Article 26 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 Sweden concerning the taxes covered by the Convention. This article covers all taxes imposed by the two Contracting States. 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 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.

Paragraph 1 states that information exchange is not restricted by Article 1 (Personal 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 Sweden which engages in transactions with a U.S. enterprise, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Similarly, if a third-country resident maintains a bank account in Sweden, 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 Sweden 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. 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 legislative bodies, such as 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 may be disclosed in public court proceedings or in judicial decisions.

It is contemplated that the Contracting States will utilize Article 26 to exchange information on a routine basis, on request in relation to a specific case, or spontaneously.

Paragraph 2 explains that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures which are at variance with the laws or administrative practice of either State. Nor does that paragraph require a Contracting State to supply information not obtainable under the laws or administrative practice of either State, or to disclose trade secrets or other information, the disclosure of which would be contrary to public policy (ordre public) . However, either Contracting State may, subject to the limitations of this paragraph and its internal law, provide information which it is not obligated to provide under this Article.

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 usable in the judicial proceedings of the requesting State. The requested State should, if possible, 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 clarifies that the competent authorities may settle the mode of application of this Article. Types of information exchange that may be used include spontaneous and industry-wide exchanges of information, information exchanges on request, and simultaneous tax examinations.

Paragraph 5 provides that the competent authorities may exchange information concerning every tax imposed by a Contracting State, not just the taxes listed in Article 2 (Taxes covered).

Article 27 - ADMINISTRATIVE ASSISTANCE

Article 27 deals with administrative assistance between Contracting States in the collection of taxes.

Paragraphs 1, 2, and 3 are similar to Article XVII of the prior Convention. Under these paragraphs, the States agree to lend assistance in collection of the taxes that are the subject of the Convention, along with interest, costs, and additions to the taxes. The taxes to be collected must be finally determined in the requesting State, as established by documents accompanying the request. 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. The requested State will use the procedures that it uses in the collection of its own taxes.

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 insure that the benefits of the Convention are enjoyed only by persons entitled to those benefits under the terms of the Convention. Under this paragraph, assistance will be provided in those cases where 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.

Paragraph 5 makes clear that the Contracting 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, or that would be contrary to its sovereignty, security or public policy.

Article 28 - DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Article 28 confirms that any fiscal privileges to which diplomatic agents 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. 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 5(b) of Article 1 (Personal scope)).

Article 29 - ENTRY INTO FORCE

The Convention is subject to ratification. Instruments of ratification will be exchanged at Washington, D.C.

The Convention enters into force on the date on which the instruments of ratification are exchanged. Its provisions with respect to United States withholding taxes will have effect for amounts paid or credited on or after January 1 following the date on which the Convention enters into force. With respect to other United States taxes, the provisions will have effect for taxable years beginning on or after that same date. The Convention's provisions with respect to Swedish taxes on income will have effect for income derived on or after January 1 of the year following the year that the Convention enters into force. With respect to Swedish capital taxes, the provisions will have effect for taxes assessed in or after the second calendar year following the year the Convention enters into force. Thus, for example, if instruments of ratification are exchanged in July 1995, the provisions of the Convention will take effect as of January 1, 1996 for United States withholding taxes, for taxable years beginning on or after January 1, 1996 for other United States taxes, January 1, 1996 for Swedish taxes on income, and for taxable years taxes assessed in or after January 1, 1997 for Swedish capital taxes.

The coming into effect of the Convention will terminate the Convention of March 23, 1939, and the Supplementary Convention of October 22, 1963. The provisions of the Prior Convention will cease to have effect when the comparable provisions of the Convention become effective. The 1939 Convention will be applied to Swedish capital taxes until the first year after the year in which the Convention enters into force.

Article 30 - TERMINATION

The Convention shall remain in force indefinitely unless terminated by one of the Contracting States. Either State may terminate the Convention after five years from the date on which it enters into force by giving at least six months prior notice through diplomatic channels. In that event, the Convention will cease to have effect with respect to United States taxes withheld at the source for amounts paid or credited on or after January 1 following the expiration of the six-month period, with respect to other United States taxes for taxable periods beginning on or after January 1 following the expiration of the six-month period, with respect to Swedish taxes on income for income derived on or after January 1 following the expiration of the six-month period, and with respect to Swedish capital taxes for taxes assessed in or after the second calendar year following the expiration of the six-month period.

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE UNITED STATES OF AMERICA AND THE PORTUGUESE REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME SIGNED AT WASHINGTON ON SEPTEMBER 6, 1994

INTRODUCTION

This is a technical explanation of the Convention between the United States and Portugal signed on September 6, 1994 (the "Convention"). The Convention is based on the U.S. Treasury Department's former draft Model Income Tax Convention, published on June 16, 1981, the Model Tax Convention on Income and Capital published by the OECD in 1992 (the "OECD Model"), and recent U.S. and Portuguese income tax conventions. Although the former U.S. Model has been withdrawn pending development of a new model, it was relevant at the time during which much of 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 terms "he" or "his" should be read to mean also "she" or "her."

Article 1. GENERAL SCOPE

This article provides that the Convention is applicable to residents of the United States or Portugal 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 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 26 (Non-Discrimination) and 28 (Exchange of Information).

Paragraph 1 of the Protocol contains the other provisions normally included in the General Scope Article of U.S. income tax treaties. Subparagraph 1(a)(i) of the Protocol explains that the Convention may not restrict any exclusion, exemption, deduction, credit, or other benefit accorded by the tax laws of the Contracting States. In effect, subparagraph 1(a)(i) provides that the Convention may not increase the overall tax burden on a resident of a Contracting State beyond the burden imposed 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 taxation.

Under the principle of subparagraph 1(a)(i), a taxpayer's U.S. tax liability need not be determined under the Convention if the Internal Revenue 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 Portuguese 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 would be taxable, and both the profit and the loss of the other two businesses would be 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. 308.) 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.

Subparagraph 1(a)(i) of the Protocol also provides that the Convention does not override any benefit provided under other bilateral agreements that were in force as of the date on which the Convention was signed (September 6, 1994).

Subparagraph 1(a)(ii) of the Protocol affects obligations undertaken by the Contracting States under other agreements. Subparagraph 1(a)(ii) of the Protocol provides that, notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning whether a measure is within the scope of this Convention shall be considered only by the competent authorities of the Contracting States, as defined in this Convention, and the procedures under this Convention exclusively shall apply to the dispute. Thus, dispute resolution procedures provided for in trade, investment, or other agreements between the Contracting States shall not apply for the purpose of determining the scope of the Convention.

Subparagraph 1(a)(iii) of the Protocol provides that, unless the competent authorities agree that a taxation measure is not within the scope of this Convention, the nondiscrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favored-nation ("MFN") obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade ("GATT"). No national treatment or MFN obligation under any other agreement shall apply with respect to that measure. Thus, any national treatment and MFN obligations undertaken by the Contracting States under agreements other than the Convention, with the exception of GATT as applicable to trade in goods, shall not apply to a taxation measure.

Subparagraph 1(a)(iv) of the Protocol defines a "measure" as a law, regulation, rule, procedure, decision, administrative action, or any other form of measure.

Subparagraph 1(b) of the Protocol contains the traditional U.S. treaty "saving clause." Under this paragraph, each Contracting State may tax its residents, and the United States may tax its citizens, in accordance with its domestic law, notwithstanding any Convention provision to the contrary. If, for example, a Portuguese 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 Portuguese 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 concerning U.S. taxation of certain income of U.S. citizens resident in Portugal are provided in paragraph 2 of Article 25 (Relief from Double Taxation).

For purposes of the saving clause of paragraph 1(b) of the Protocol, residence is determined under Article 4 (Resident).

Subparagraph 1(b) of the Protocol states that the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for the period of 10 years following such loss. This permits the United States to apply the rules of Code section 877. Subparagraph 1(b) of the Protocol concludes by providing that, upon request by the Portuguese competent authority, the competent authorities will consult under Article 27 (Mutual Agreement Procedure) on the purposes of such loss of citizenship. Thus, if the United States taxes a former U.S. citizen who is a resident of Portugal, the Portuguese competent authorities may request a discussion with their U.S. counterparts of the circumstances involved in the case.

Subparagraph 1(c) of the Protocol lists several exceptions to the saving clause, under which benefits granted by a Contracting State under the Convention are extended to its citizens and residents. Under subparagraph 1(c)(i), U.S. residents and citizens are entitled to the following U.S. benefits provided under the Convention: the corresponding adjustments authorized by paragraph 2 of Article 9 (Associated Enterprises); the provisions of paragraph 3 of Article 14 (Capital Gains) regarding gain from the alienation of certain property; the exemption from U.S. tax of social security benefits paid by Portugal that is provided in subparagraph 1(b) of Article 20 (Pensions, Annuities, Alimony, and Child Support); the exemption from U.S. tax of child support payments paid by a Portuguese resident that is provided in paragraph 4 of Article 20 (Pensions, Annuities, Alimony, and Child Support); the foreign tax credit provisions of Article 25 (Relief from Double Taxation); the nondiscrimination protection of Article 26 (Non-Discrimination); and the competent authority procedures of Article 27 (Mutual Agreement Procedure).

Subparagraph 1(c)(ii) of the Protocol provides additional exceptions to the saving clause for individuals resident in a Contracting State who are neither citizens of, nor have immigrant status in, that State. These exceptions preserve the benefits extended by the United States under the Convention to persons other than U.S. citizens and "green card" holders who are: employees of the Portuguese Government under Article 21 (Government Service); visiting teachers or researchers under Article 22 (Teachers and Researchers); visiting students or trainees under Article 23 (Students and Trainees); or members of

diplomatic or consular missions under Article 29 (Diplomatic Agents and Consular Officers).

Article 2. TAXES COVERED

This Article identifies the U.S. and Portuguese taxes to which all articles of the Convention apply. Certain provisions of the Convention and the Protocol are also applicable, however, with respect to certain taxes in addition to those specified in Article 2. For example, Article 26 (Non-Discrimination) applies with respect to all taxes imposed at all levels of government, including state and local governments. Article 28 (Exchange of Information) applies with respect to all taxes imposed by a Contracting State (i.e., at the national level). Paragraph 8 of the Protocol applies with respect to the substitute gift and inheritance tax (Imposto sobre Sucessoes e Doacoes por Avenca) imposed by Portugal.

In the case of Portugal, the Convention generally applies to the personal income tax (Imposto sobre o Rendimento das Pessoas Singulares-IRS), the corporate income tax (Imposto sobre o Rendimento das Pessoas Colectivas-IRC), and the local surtax on corporate income tax (Derrama). As noted above, other provisions, such as Articles 26 (Non-Discrimination) and 28 (Exchange of Information) of the Convention and paragraph 8 of the Protocol, apply to certain additional taxes.

In the case of the United States, the Convention generally applies to the Federal income taxes imposed by the Internal Revenue Code. 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 with respect to the excise taxes imposed on insurance premiums paid on policies issued by foreign insurers under Code section 4371. The social security taxes provided in Code sections 1401, 3101, and 3111 are generally excluded from coverage. However, as noted above, certain other provisions of the Convention, such as Articles 26 (Non-Discrimination) and 28 (Exchange of Information), apply to all taxes imposed by the United States, including the insurance premiums excise taxes and the social security taxes. In addition, as in other U.S. treaties, Article 26 (Non-Discrimination) applies to taxes imposed by state and local governments.

Under paragraph 2 of Article 2 (Taxes Covered), 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 6, 1994 (the date of signature of the Convention). Paragraph 2 also provides that the U.S. and Portuguese competent authorities will notify each other of changes in their taxation laws 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.

Paragraph 2 of the Protocol provides additional information regarding taxes that are and are not covered. Paragraph 2(a) of the Protocol clarifies that Article 2 does not apply to social security contributions established under Portuguese law. These amounts are not covered because, as under the U.S. system, they are treated as contributions to Portugal's social security system, not as taxes. As noted above, Article 2 itself makes clear that U.S. social security contributions are not covered.

Subparagraph 2(b) of the Protocol limits the application of the Convention with respect to the personal holding company tax (Code section 541) and the accumulated earnings tax (Code section 531). Subparagraph 2(b)(i) exempts a Portuguese company from liability for the personal holding company tax only for taxable years in which all of the Portuguese company's stock is owned by individuals who are not residents or citizens of the United States, in their capacity as individuals. Thus, if there is any owner that is not an individual, or any owner that is a U.S. citizen or U.S. resident, the Portuguese company may be liable for the personal holding company tax. Under subparagraph 2(b)(ii) of the Protocol, Portuguese companies that are described in paragraph 1(c) of Article 17 (Limitation on Benefits), which pertains to certain publicly traded companies, are exempt from the accumulated earnings tax. In general, this is intended to relieve such a Portuguese company from any obligation to prove that its earnings and profits have not accumulated beyond the reasonable needs of the company. It is understood that such publicly traded companies are unlikely to be mere holding or investment companies and that the interests of the shareholders of such companies are likely to operate so as to prevent an unreasonable accumulation of earnings and profits.

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 all purposes of the Convention, 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 Portugal, depending on the context in which the term is used.

Subparagraph 1(b) defines the term "Portugal" to mean the Portuguese Republic. This includes the territory on the European Continent and the archipelagoes of Azores and Madeira, the respective territorial seas and any other zone in which, in accordance with the laws of Portugal and international law, the Portuguese Republic has sovereign rights with respect to the exploration and exploitation of the natural resources of the seabed and subsoil and of the superjacent waters.

Subparagraph 1(c) defines the term "United States" to mean the United States of America. The term does not include Puerto Rico or the Virgin Islands, Guam, or any other U.S. possession or territory. When used in a geographical sense, the term "United States" includes the States, the District of Columbia, the territorial sea adjacent to those States, and any other zone adjacent thereto over which, in accordance with the laws of the United States and international law, the United States has sovereign rights with respect to the exploration and exploitation of the natural resources of the seabed and subsoil and of the superjacent waters.

Subparagraph 1(d) defines the term "person" to include an individual, a company, and any other body of persons. This definition is consistent which that used in the OECD Model and in other U.S. treaties. Any person that qualifies as a "resident" of a Contracting State under Article 4 (Resident) is entitled to the benefits of the Convention, subject to the provisions of Article 17 (Limitation on Benefits).

Subparagraph 1(e) defines the term "company" as any body corporate or any entity treated as a body corporate for tax purposes. In the case of the United States, the rules of Treas. Reg. §301.7701-2 generally will apply to determine whether an entity is an association taxable as a corporation, and thus is a company, for purposes of the Convention. Similarly, in the case of the United States, a publicly traded partnership that is treated as a corporation under 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 "national" to mean any individual possessing the nationality of a Contracting State and

any legal person, association, or other entity deriving its status as such from the laws in the force in a Contracting State. This definition, which comes from the OECD Model, has been used in other U.S. treaties. In the case of the United States, the term "national" means a U.S. citizen when applied to an individual.

Subparagraph 1(h) 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 Portuguese carrier (if permitted) would not be treated as international traffic. If, however, goods or passengers were carried by a Portuguese airline from Lisbon to New York and then to Chicago, the entire trip would be considered international traffic. This would be true even if a Portuguese 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 Portuguese carrier, so long as both parts of the trip were reflected in the original bill of lading.

Subparagraph 1(i) defines the term "competent authority." The competent authorities of the Contracting States 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 Portugal, the competent authority is the Minister of Finance, the Director General of Taxation (Director Geral das Contribuicoes e Impostos), or their authorized representative.

Paragraph 2 of Article 3 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 27 (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, 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. However, the fact that a person is determined to be a resident of a Contracting State under Article 4 does not necessarily entitle that 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 taxation laws of the Contracting State involved. Thus, a person that is liable to tax under the laws of a Contracting State by reason of its domicile, residence, place of management, place of incorporation, or any other similar criterion is treated as a resident of that State. A person that, under those laws, is a resident of one Contracting State and not of the other generally need look no further.

Paragraph 1 concludes with an exception to the general rule of this paragraph. 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 Portuguese 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.)

Paragraph 2 provides a series of tie-breaker rules to determine a single State of residence for an individual who, under the laws of each Contracting State, and thus under paragraph 1, is deemed to be a resident of both Contracting States. These rules, which are generally included in U.S. treaties, 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 this 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, he will be treated as a resident of the Contracting State of which he is a citizen. If he is a citizen of both States or of neither, the competent authorities are instructed to determine his residence by mutual agreement.

Paragraph 3 seeks to settle dual-residence issues for persons other than individuals. A corporation is treated as a resident in the United States if it is created or organized under the laws of the United States or a political subdivision thereof. In Portugal, a corporation is treated as a resident of Portugal if it is either incorporated there or managed and controlled there. Dual residence, therefore, can arise if a U.S.-incorporated corporation is managed in Portugal. Since neither party was prepared to give up its test of corporate residence under a tie-breaker rule, the paragraph provides that if a corporation or other person, other than an individual, is resident in both the United States and Portugal under paragraph 1, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention. If, however, they are unable to reach agreement, that person shall not be considered to be a resident of either the United States or Portugal for purposes of deriving any benefits of the Convention. Since it is only for the purposes of deriving treaty benefits that such dual residents are excluded from the Convention, they may be treated as resident for other purposes. For example, if a dual resident corporation pays a dividend to a resident of Portugal, the U.S. withholding agent would be permitted to withhold on that dividend at the appropriate treaty rate, since reduced withholding is a benefit enjoyed by the resident of Portugal, not by the dual resident. The dual resident corporation that pays the dividend would, for this purpose, be treated as a resident of the United States under the Convention.

Paragraph 3 of the Protocol provides further guidance on the issue of residence. Under subparagraph 3(a) of the Protocol, a partnership, similar pass-through entity, estate, or trust will be treated as a resident of a Contracting State to the extent that the income derived by the partnership, similar pass-through entity, estate, or trust is subject to tax in that State as the income of a resident, whether in the hands of the entity deriving the income or in the hands of its partners, members, beneficiaries, or grantors. This rule is applied to determine the extent to which income received by or through an estate, trust, partnership, or similar pass-through entity such as a U.S. limited liability company, from the other Contracting State is entitled to Convention benefits.

Under U.S. law, partnerships (other than certain publicly traded limited partnerships and partnerships that are classified as associations under Treas. Reg. § 301.7701-2) are never, and estates and trusts often are not, taxable entities. Thus, for Convention purposes, income received by a U.S. partnership generally is treated as received by a U.S. resident only 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 circumstances.

Subparagraph 3(b)(i) of the Protocol confirms that the term "resident of a Contracting State" includes any not-for-profit organization constituted and maintained in that State, provided that the laws of such State or of a political or administrative subdivision thereof limit the use of the organization's resources, both currently and upon the dissolution or liquidation of such organization, to the accomplishment of the purposes that serve as the basis for such organization's exemption from income tax. Subparagraph 3(b)(ii) of the Protocol similarly confirms that a pension trust or any other organization or arrangement that is constituted and operated exclusively to provide pension, retirement, or employee benefits and that is established or sponsored by a person that is otherwise a resident of a Contracting State under Article 4 (Residence) is to be treated as a resident of that State for purposes of the Convention. This is the case notwithstanding the fact that all or part of the income of the organization, trust, or other arrangement may be exempt from income tax under the domestic laws of that State.

Under subparagraph 3(c) of the Protocol, 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 Portugal for purposes of the Convention only if such individual has a substantial presence in the United States or would be treated as a resident of the United States and not of a third country under the principles of subparagraphs (a) and (b) of paragraph 2 of Article 4 (Residence). Therefore, a U.S. citizen or "green card" holder whose permanent home, center of vital interests, and habitual abode are neither in the United States nor in Portugal, and who does not have a substantial presence in the United States, generally will not be entitled to benefits under the Convention. (However, as noted above in connection with Article 1 (Personal Scope), limited Convention benefits are available to certain persons who are not residents of either Contracting State.)

The Article does not contain the explicit provision, found in some U.S. treaties, that the government of a Contracting State is a resident of that State. It was not considered necessary to clarify this point, because it is understood by both Portugal and the United States that the Government of each Contracting State and political or administrative subdivisions and local authorities thereof are residents of that State for purposes of the Convention.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment," which is relevant to several articles of the Convention. For example, under Article 7 (Business Profits), a Contracting State may not tax the business profits of a resident of the other Contracting State unless that resident has a permanent establishment in the first 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 15 (Independent Personal Services) uses the concept of a "fixed base," rather than a "permanent establishment," but the two concepts are considered to be similar.

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 forms a commercial and geographical whole.

Paragraph 3 adds that the term "permanent establishment" also includes a building site or a construction installation or assembly project, supervisory activities in connection with such a site or project, or an installation or drilling rig or ship used for the exploration or development of natural resources, but only if such site, project, or activities last more than 6

months. This 6-month threshold 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 commercially and geographically interdependent 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 were constructed for a different purchaser. Likewise, the drilling of several wells within the same geographic area would be considered a single permanent establishment. If the 6-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.

Paragraph 4 provides that, notwithstanding the preceding provisions of this Article, an enterprise of a Contracting State that carries on business of a permanent nature in the other Contracting State through its own employees or any other personnel engaged for such purpose for a period or periods totalling 9 months or more in any 12-month period commencing or ending in the taxable year concerned shall be deemed to have a permanent establishment in the other State. In this context, "business of a permanent nature" is intended to suggest business other than that of a preparatory or auxiliary character. The 9-month rule of this paragraph is, however, limited by paragraph 4 of the Protocol, which states that the provisions of this paragraph shall apply only for the first 5 years in which the provisions of the Convention have effect. For example, if the Convention were to enter into force on July 3, 1995, paragraph 4 of Article 5 (Permanent Establishment) would be in effect only for taxable periods beginning on or after January 1, 1996 and before January 1, 2001.

Paragraph 5 is drawn directly from the OECD Model and 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 5(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 5(b) and 5(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 5(d) and 5(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 5(f), a combination of the activities described in paragraph 5 will not give rise to a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. This is the same as the corresponding provision in many other U.S. income tax treaties, as well as in the OECD Model.

Paragraphs 6 and 7 specify when the activities of an agent will give rise to a permanent establishment. Under paragraph 6, an enterprise will be deemed to have a permanent establishment as a result of the activities of a dependent agent 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 5 that would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the activities of the agent will not cause the enterprise to be deemed to have a permanent establishment.

Under paragraph 7, 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 8 provides 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 State or that carries on business in that other State. The determination of whether a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 7 of the Article and paragraph 4 of the Protocol. 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 IMMOVABLE PROPERTY (REAL PROPERTY)

Paragraph 1 provides the general rule that income derived by a resident of a Contracting State from immovable property (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.

Paragraph 2 defines the term "immovable property" or "real property" by reference to the domestic law of the situs State. In addition, the paragraph specifies certain classes of property that, regardless of domestic law definitions, are to be included within the meaning of the term for purposes of the Convention. It also specifies that the term "real property" does not include ships or aircraft in any event.

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 income derived from real property and is not covered by this Article. The taxation of such amounts is addressed in Article 14 (Capital 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 income 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 even if such income is not attributable to a permanent establishment or fixed base of an enterprise of that resident in the situs State.

The provision in the former U.S. Model for a binding election by the taxpayer to be taxed on real property income on a net basis was not included in the Convention. Portugal permits taxation on a net basis only if the income is attributable to a permanent establishment. Otherwise, tax is imposed on the gross amount, subject to a withholding of 25 percent by the payer. This is similar to the situation with Spain.

Paragraph 5 of the Protocol clarifies that the provisions of Article 6 also apply to income from associated personal property and from the provision of services for the maintenance or operation of real property.

Article 7. BUSINESS PROFITS

This Article provides 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 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 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 and dealing wholly independently with the enterprise of which it is a permanent establishment and with any other associated enterprise. 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), 13 (Royalties), 15 (Independent Personal Services), and 24 (Other Income) dealing with amounts attributable to a permanent establishment or fixed base. If income is attributable to a permanent establishment or fixed base, it is taxable by the State where the permanent establishment or fixed base was located, even if the income is deferred (_i.e._, not taken into account) until the permanent establishment or fixed base has ceased to exist.

The concept of "attributable to" in paragraph 2 is analogous to, but somewhat 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)(3) is consistent with paragraph 2, _i.e._, the items of foreign source income described in Code section 864(c)(4)(B) may be attributed to a U.S. permanent establishment of a Portuguese resident and subject to tax in the United States. The limited "force of attraction" rule in Code section 864(c)(3) is not applicable under the Convention, however, because only those profits attributable to a permanent establishment's assets or activities may be taxed by the Contracting State in which the permanent establishment is located.

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 for the purposes of the permanent establishment. Such expenses include, but are not limited to, research and development expenses, interest, and executive and general administrative expenses, wherever incurred and without regard to whether they are actually reimbursed by the permanent establishment.

In connection with paragraph 3, paragraph 6 of the Protocol confirms that it is understood that each Contracting State may apply its own domestic law, whether based on tracing or allocation, for attributing research and development expenses, interest, and other similar expenses to a permanent establishment situated in its territory, provided that such rules are consistent with the provisions of Article 7. This language confirms that the United States may apply its expense allocation rules under Treas. Reg. §§ 1.861-8 and 1.882-5.

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 5(d) of Article 5 (Permanent Establishment), the office would not be a permanent establishment to which profits could be attributed.

Paragraph 5 is 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, 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, e.g., Code section 481).

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 other articles will take precedence over the provisions

of Article 7, except where they specifically provide to the contrary. 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 6 of Article 11) the interest is attributable to a permanent establishment.

This Article is subject to the "saving clause" of subparagraph 1(b) of the Protocol. Thus, if a citizen of the United States who is a resident of Portugal 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 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 are exempt in that other State even if the enterprise has a permanent establishment there.

Paragraph 2 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 Portuguese airline, TAP, were to form a consortium with airlines of other countries, the Portuguese participant's share of the total income derived by the consortium from U.S. sources would be covered by this Article.

Paragraph 7 of the Protocol clarifies what income is to be considered profits from the operation of ships or aircraft. It specifies that the term "income from the operation of ships or aircraft in international traffic" is to be interpreted in accordance with paragraphs 5 to 12 of the Commentary to Article 8 of the 1992 OECD Model. As such, it is understood that full charters of ships and aircraft used in international traffic are covered by paragraph 1. International shipping profits include rents from bareboat charters made by shipping and aircraft companies only when such charters are occasional and incidental to the international traffic operations of those companies. Rental income from bareboat charters that are not occasional and incidental to the lessor's international traffic operations are not covered by this Article, but may be covered by other articles

of the Convention, such as Article 13 (Royalties) or Article 7 (Business Profits). Thus, if an oil company that owns a deep-water tug (used in its offshore oil explorations) were to make a bareboat rental of that tug during periods of idle use, the income from such rental would not be covered by Article 8 because such company is not normally engaged in international traffic. It is also understood that the occasional and incidental leasing of terminal facilities for the loading and unloading of cargo or passengers would be auxiliary activity covered by the definition of international shipping profits if carried on by an operating company.

The "profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic" include those profits accruing to the enterprise that are attributable to transport between places in the other Contracting State when such transport is in connection with or incidental to transport outside of the other Contracting State, regardless of whether such transport is actually conducted by the enterprise. That is, because such transport is not solely between places within the other Contracting State but, rather, is in connection with or incidental to transport outside of the other Contracting State, such transport is covered by the definition of international traffic. For example, when a shipping enterprise of a Contracting State undertakes to provide, in connection with such transport, for the transshipment and delivery by rail of the transported goods to a consignee within the other Contracting State and derives profits from either direct payments by the consignee or commissions from the transshipment agent, such profits are part of the shipping enterprise's profits from the international traffic and, as such, are not taxable in the other Contracting State.

Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers, and related equipment for the transport of containers, used for the transport of goods or merchandise in international traffic are treated as royalties, unless attributable to a permanent establishment. However, paragraph 11 of the Protocol provides that such royalties are taxable only by the Contracting State of which the recipient is a resident. It is understood that in the context of paragraph 11 of the Protocol, the term "containers" includes related equipment incidental to the transport of containers, such as cranes and trailers.

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 an appropriate 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 a corresponding adjustment under this paragraph will take the other provisions of the Convention into account. For example, if the effect of a corresponding adjustment is to treat a Portuguese 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 27 (Mutual Agreement Procedure) requires that any corresponding adjustment made under paragraph 2 of this Article be implemented notwithstanding any time limits or procedural limitations in the law of the Contracting State making the adjustment.

The "saving clause" of subparagraph 1(b) of the Protocol does not apply to paragraph 2 of this Article. Thus, U.S. benefits are also available to U.S. citizens and residents. Therefore, 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 made in order to implement a corresponding adjustment. Statutory or procedural limitations,

however, cannot be overridden to impose additional tax, because, under subparagraph 1(a) of the Protocol, the Convention cannot restrict any statutory benefit.

Paragraph 3 simply confirms that this Article does not restrict the provisions of either Contracting State's domestic law relating to the determination of the tax liability of a person, provided that the determination is consistent with the principles stated in this Article, i.e., that the adjustment reflects what would have transpired had the related parties been acting at arm's length. Thus, a Contracting State is free to make adjustments to losses or credits, for example, to the extent permitted under its domestic law and the arm's-length principles of this Article, although such adjustments are not specified in paragraph 1.

Article 10. DIVIDENDS

This Article provides rules for the taxation of dividends paid by a company resident in one Contracting State to a resident of the other Contracting State. The article permits full residence State taxation and limited source State taxation of such dividends.

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.

Paragraph 2 grants the source State the right to tax dividends paid by a company that is a resident of that State to a beneficial owner that is a resident of the other Contracting State. The source State tax is limited to 15 percent of the gross amount of the dividend. Use of the term "beneficial owner" emphasizes that substance will prevail over form in determining the appropriate tax treatment, so that treaty benefits may be denied to a nominal recipient not entitled to the beneficial enjoyment of the dividend income.

In the absence of such a provision, the United States would apply its statutory withholding rate of 30 percent to dividends paid to a Portuguese resident, and Portugal would apply its statutory withholding rate of 25 or 15 percent to dividends paid to a U.S. resident.

Paragraph 2 also provides that the competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this rate limitation. For example, they may agree on procedures whereby determinations are made as to who is entitled to the reduced withholding rate under this provision.

Paragraph 2 does not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Paragraph 3 provides for a lower rate of taxation at source if the beneficial owner is a company that is a resident of the other Contracting State and that, for an uninterrupted period of 2 years prior to the payment of the dividend, owned directly at least 25 percent of the capital of the company paying the dividends. (The 25-percent ownership requirement and the 2-year holding period correspond to Portugal's threshold for entitlement to receive a 95-percent dividends received deduction.) It is understood that in the case of the United States "capital" refers to voting power. In the case of Portugal, "capital" refers to "social capital," the nominal paid-in value of the company's shares. The lower rate applicable to these dividends is 10 percent of the gross amount with respect to dividends paid after December 31, 1996 and before January 1, 2000. With respect to dividends paid after December 31, 1999, the rate for each of the Contracting States will be the rate Portugal may apply to such dividends paid to residents of European Union member states provided, however, that the applicable rate shall not be less than 5 percent. It is understood by both the United States and Portugal that the term "paid" means paid or credited.

Under its domestic law, Portugal also imposes a 5 percent substitute gift and inheritance tax (Imposto sobre Sucessoes e Doacoes por Avenca) on dividends paid by certain types of companies. (Portuguese legislation currently extends the 5 percent substitute gift and inheritance tax to certain types of interest, but the tax has not yet been imposed on interest payments and was recently deferred again.) That tax is not covered in this or any other Portuguese income tax treaty. However, paragraph 8 of the Protocol provides that if in the future the rate of tax is increased above 5 percent, that increase will not apply to dividends owned by residents of the United States. Portugal has never before agreed to lower this tax by treaty or to exempt a treaty partner from future rate increases. The fact that Portugal regards this substitute tax as a gift or inheritance tax, as indicated by the Protocol, does not affect the determination as to whether the tax is creditable for U.S. income tax purposes.

Paragraph 4 provides an exception to paragraph 3 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. The purpose of the reduction of the direct investment dividend rate is to relieve multiple levels of corporate taxation in cases where the recipient of the dividend holds a substantial interest in the payer. 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 certain 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 25 percent shareholding in a RIC by a Portuguese resident will correspond to a 25 percent shareholding in the entity (here, the publicly traded U.S. company) that has paid U.S. corporate tax. 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 presumed not to be satisfied.

In the case of a dividend paid by a U.S. REIT to a Portuguese resident, the U.S. statutory rate of 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 25 percent interest in the REIT are eligible, however, for the 15 percent portfolio dividend rate provided in paragraph 2. The denial of the 15 percent portfolio rate to corporate shareholders and 25 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 5 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, and income from other corporate rights that is subjected to the same taxation treatment as income from shares by the domestic laws of the Contracting State of which the company making a distribution is a resident. This is consistent with the definition used in many U.S. treaties and in the OECD Model. Paragraph 5 adds that income from arrangements, including debt obligations, will also be a dividend, 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. In the case of Portugal, the term also includes profits attributed under an arrangement for participation in profits (associacão en participacão).

Paragraph 6 provides that, where dividends are attributable to a permanent establishment or fixed base that the beneficial owner maintains in the source State, they are not subject to the provisions of paragraph 1, 2, and 3 of this Article, but instead are taxable under Article 7 (Business Profits) or Article 15 (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.

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 is effectively connected with a permanent establishment or a fixed base situated in that other State.

Article 11. INTEREST

Paragraph 1 confirms that interest may be taxed by the State in which the recipient is resident. Paragraph 2 provides that interest arising in a Contracting State may also be taxed by that State in accordance with its laws. However, if the beneficial owner of such interest is a resident of the other Contracting State, then any tax so charged may not exceed 10 percent of the gross amount of the interest. Use of the term "beneficial owner" emphasizes that substance will prevail over form in determining the appropriate tax treatment, to deny treaty benefits to a nominal recipient not entitled to the beneficial enjoyment of the interest.

In the absence of paragraph 2, Portugal generally would tax interest at 20 percent, and the United States would impose its 30 percent statutory withholding rate on interest other than portfolio interest.

Paragraph 2 also provides that the competent authorities shall agree on how to implement this Article, for example on procedures whereby determinations are made as to who is entitled to the reduced withholding rate provided by this Article (Interest).

Paragraph 3 provides three cases where source-based taxation of interest is eliminated: (1) when the debtor is the government of the Contracting State, a political or administrative subdivision thereof, or any of its local authorities; (2) when the recipient of the interest arising in a Contracting State is the government of the other Contracting State, its political subdivisions, or local authorities, or an institution or organization wholly owned by them; and (3) when the interest is on a loan with a term of 5 years or more granted by a bank or other financial institution that is a resident of the other Contracting State. The second exemption, where the creditor is the other government, a subdivision or local authority thereof, or a wholly government-owned institution is broader than the exemption provided under Code section 892, but is similar to the rule in several other U.S. income tax treaties. It is principally intended to benefit Eximbank and OPIC. Under its domestic law, Portugal would tax interest paid to those U.S. Government lending institutions.

Paragraph 9 of the Protocol reserves the right of the United States to tax an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (REMIC) in accordance with its law. Thus, Portuguese residents will be taxed on such excess inclusions at the U.S. statutory rate of withholding tax (i.e., 30 percent).

Paragraph 4 provides an exception to paragraphs 2 and 3 whereby interest arising in one of the Contracting States that is determined by reference to the profits of the issuer or of one of its associated enterprises and that is beneficially owned by a resident of the other Contracting State may be taxed in the State in which it arises, and according to the laws of that State, but the tax so charged shall not exceed the 15-percent rate prescribed in paragraph 2 of Article 10 (Dividends).

Paragraph 5 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 5 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, 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.

Paragraph 6 provides an exception from the general 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 base 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 15 (Independent Personal Services), respectively. This rule applies even if the permanent establishment or fixed base no longer exists when the interest is taken into account, as long as the interest would have been attributable to the permanent establishment or fixed base if it had been taken into account in the earlier year (i.e., where the debt claim on which the interest is paid was attributable to the permanent establishment in such earlier year).

Paragraph 7 provides a source rule for interest for purposes of this Article. Under this paragraph, interest is deemed to arise in a Contracting State when the payer is a resident of that State or the State itself, or a political or administrative subdivision or local authority thereof. 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 the interest is borne by such permanent establishment or fixed base, then the interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

Paragraph 8 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 Portugal, 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).

Article 12. BRANCH TAX

Article 12 and paragraph 10 of the Protocol explicitly confirm the right of each Contracting State to impose a branch tax, that is, a tax imposed by a Contracting State on the earnings of an enterprise of the other Contracting State through a permanent establishment in the first Contracting State. Such a branch tax imposed on payments or deemed payments from branch to home office is analogous to the withholding taxes that would be imposed on the dividends and interest payments made by a subsidiary to a parent corporation.

In the case of the United States, paragraph 1(a) defines the amount of branch profits subject to the tax as the portion of the business profits of the corporation attributable to a permanent establishment in the United States--or subject to tax in the United States on a net basis under Article 6 (Income from Immovable Property (Real Property)) or paragraph 1 of Article 14 (Capital Gains)--that represents the "dividend equivalent amount" (see Code section 884(b)).

Paragraph 1(b) also covers both interest paid and excess interest payments, as defined by Code section 884(f), deemed to be received by a Portuguese corporation for which deductions are allowable for purposes of determining income attributable to its U.S. permanent establishment (or taxable on a net basis in the United States as income from real property or gain on real property), to the extent such deductible amounts exceed the interest paid by the permanent establishment or trade or business.

Paragraph 2 provides the rate at which tax may be imposed on the "dividend equivalent amount" and the interest amounts described in paragraph 1. For the "dividend equivalent amount,"

the rate shall not exceed 15 percent (or, after 1997, the lower rate applicable under paragraph 3 of Article 10 (Dividends)). In general, branch interest may be taxed at not more than 10 percent. However, in recognition of the withholding tax exemption for long-term bank loans under Article 11 (Interest), the rate with respect to excess interest amounts of the U.S. permanent establishment of a Portuguese bank is limited to 5 percent, an average of the general 10 percent rate and the exemption applicable to interest on long-term bank loans. A similar average rate has been used for this purpose in other U.S. treaties, including the recent treaty with Spain.

Portugal does not presently impose a branch tax. However, paragraph 10 of the Protocol provides complementary treatment for Portugal with respect to the branch profits taxes described in paragraphs 1 and 2 in the event that Portugal enacts a branch profits tax in the future.

Article 13. ROYALTIES

Article 13 confirms that royalties may be taxed by the Contracting State in which the recipient is resident. Royalties arising in a Contracting State may also be taxed by that State in accordance with its laws. However, if the beneficial owner of such royalties is a resident of the other Contracting State, then any tax so charged may not exceed 10 percent. Use of the term "beneficial owner" emphasizes that substance will prevail over form in determining the appropriate tax treatment, so that treaty benefits may be denied to a nominal recipient not entitled to the beneficial enjoyment of the royalty income.

In the absence of paragraph 2, Portugal would apply its statutory withholding rate of 25 or 15 percent on royalties and the United States would impose its statutory rate of 30 percent.

Paragraph 2 provides that the competent authorities may agree on procedures whereby determinations are made as to who is entitled to the reduced withholding rate provided in this Article.

Paragraph 3 defines the term "royalties" as used in the Convention. 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, any patent, trademark, design or model, plan, secret formula or process, or other like right or property; for the use or the right to use industrial, commercial, or scientific equipment; or for information concerning industrial, commercial, or scientific experience. The reference to "other means" of reproduction makes clear that subsequent technological advances will not affect the treatment of payments

relating to the use of such means of image or sound reproduction from the definition of royalties. The definition of royalties also includes payments for technical assistance performed in a Contracting State by a resident of the other State where such assistance is related to the application of any such right or property. In addition, the term "royalties" includes gains derived from the use of such right or property to the extent that such gains are contingent on the productivity, use, or further disposition of the property.

The United States prefers to provide a treaty exemption at source for royalties arising in one Contracting State and derived and beneficially owned by a resident of the other Contracting State and to exclude equipment rental income from the definition of royalties. However, like a number of countries, Portugal objects strongly to these positions. The maximum treaty rate of 10 percent represents a significant reduction of the Portuguese domestic law rate. The United States has accepted this rate and equipment rental rule in other recent treaties (see, e.g., Mexico, Spain).

As noted earlier in the discussion of Article 8, paragraph 11 of the Protocol provides that royalties received in consideration for the use of, or the right to use containers in international traffic shall be taxable only in the Contracting State of which the recipient is a resident, unless attributable to a permanent establishment in the other Contracting State. (See below.)

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 or has performed 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 15 (Independent Personal Services), respectively, 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 taken into account, as long as the royalties would have been attributable to the permanent establishment or fixed base if they had been taken into account in the earlier year (i.e., where the license in respect of which the royalties are paid was attributable to the permanent establishment in such earlier year).

Paragraph 5 provides rules for determining the source of royalty payments. Royalties paid by a resident of a Contracting State or by the government of a Contracting State, or a political or administrative subdivision or local authority thereof, generally are considered to have their source in that State. If the royalties are attributable to a permanent establishment or fixed base located in a Contracting State, they are sourced in that Contracting State provided that they are borne by such permanent establishment or fixed base. The term "borne by" is understood to mean allowable as a deduction in computing taxable income. However, when the royalties are not borne by a permanent establishment or fixed base located in a Contracting State and the payer is not a resident of either Contracting State, then the source of the royalties is the State in which the property or rights are used. These rules are a compromise between the U.S. statutory rule, which sources royalties in the State in which the property or rights are used, and the Portuguese rule, which sources royalties according to the residence of the payer. They permit the United States to tax a royalty paid by a third country resident to a resident of Portugal for the use of property in the United States. A taxpayer who prefers the source rule of the Code may choose to be taxed under the Code, as provided in paragraph 1(a)(i) of the Protocol. However, in that case the taxpayer may not claim the rate reduction under the treaty; the taxpayer must choose between either the treaty source and rate rules or the Code source and rate rules.

Paragraph 6 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 13 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 Portugal, 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 domestic 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).

Article 14. CAPITAL 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.

Paragraph 2 clarifies that the term "real property situated in the other Contracting State" is understood to include a United States real property interest when the United States is the "other Contracting State." Thus, the United States preserves its right to collect the tax imposed by Code section 897 on gains derived by foreign persons from the disposition of United States real property interests. For this purpose, the source rules of Code section 861(a)(5) shall determine whether a United States real property interest is situated in the United States. In addition, the paragraph clarifies that real property situated in Portugal includes stock, participations, or other rights in a company or other legal person the property of which consists, directly or indirectly, principally of immovable property situated in Portugal.

The provisions of paragraph 2 apply "for the purposes of paragraph 1" of this Article 14 (Capital Gains) and have no effect on the right of a Contracting State to tax income covered in other Articles. For example, the inclusion of interests in certain corporations in the definition of "real property situated in the other Contracting State" for purposes of permitting source country taxation of gains derived from dispositions of such interests under Article 14 does not affect the treatment of dividends paid by such corporations. Such dividends remain subject to the limitations on source State taxation contained in Article 10 (Dividends) and are not governed by the unlimited source State taxation right provided in Article 6 (Income from Immovable Property (Real Property)) with respect to real property.

Paragraph 3 preserves the right of the source State to tax gains from the alienation of movable (personal) 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 or had in the other Contracting State, or of movable property pertaining to a fixed base that is or was 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. In the case of the United States, this preserves the taxing right of Code section 864(c)(7). In the case of Portugal, it preserves Portugal's statutory taxation of gain on property removed from a permanent establishment.

Subparagraph 12(a) of the Protocol acknowledges that the meaning of the term "business property," as used in this paragraph 3 of this Article, is narrower in some cases than that of the term "assets," used in paragraph 2 of this Article, despite the use in Portuguese of the same term in both places.

However, subparagraph 12(b) of the Protocol modifies paragraph 3 of the Convention by providing that removal of personal property from a Contracting State by an enterprise of the other Contracting State may be treated as an alienation of that property and taxed by the first-mentioned State only to the extent of the gains accrued on the property as of the date of removal. In this case, subsequent taxation by the State of residence of the enterprise is limited to the gains accruing after the time of removal from the first-mentioned Contracting State. For U.S. tax purposes, the taxpayer will carry over the basis of the property and will be required to substantiate its fair market value on the date of removal from Portugal in computing any subsequent gain that becomes taxable in the United States. This provision does not affect the operation of Code section 987 with respect to foreign currency gain or loss on remittances by a qualified business unit of property or currency. Under this provision, each Contracting State will limit its tax on the resident of the other Contracting State to the gain accrued on the property while in its territory. In the absence of this provision, there could be double taxation. Portugal would tax the gain accrued on the property as of the date on which property was removed from Portugal by an enterprise of the United States, and the United States would tax the full gain at the time the property was disposed of by the U.S. enterprise.

Subparagraph 12(c) of the Protocol ensures that a U.S. company that incorporates a branch in Portugal will receive the same beneficial treatment that Portugal is required to provide to a company resident in a member state of the European Union, i.e., deferral of the gain by carrying over to the subsidiary the basis of the assets of the branch. In the absence of such protection, Portugal would treat the reorganization in such a case as a taxable event and tax the gain on the assets of the branch at that time.

Paragraph 4 provides that gains derived by an enterprise of a Contracting State from the alienation of ships or aircraft operated in international traffic are taxable only in that State.

Paragraph 5 clarifies that gains from the alienation of any right or property described in Article 13 that are contingent on the productivity, use, or further disposition of the property, are taxable only in accordance with the provisions of Article 13, as provided in paragraph 3 of that Article.

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. Therefore, for example, gains from the sale of corporate shares that are not attributable to a permanent establishment of the seller in the other State will be taxable only in the State of residence of the seller.

Article 15. INDEPENDENT PERSONAL SERVICES

The Convention deals in separate articles with different classes of income from personal services. Article 15 generally deals with income from independent personal services, while Article 16 (Dependent Personal Services) generally deals with income from employment. Exceptions and additions to these general rules are provided for directors' fees in Article 18; for performance income of artistes and sportsmen in Article 19; for pensions in respect of personal service income and social security benefits in Article 20; for government service salaries and pensions in Article 21; for certain income of teachers and researchers in Article 22; and for certain income of students and trainees in Article 23.

Under paragraph 1, income derived by an individual who is a resident of one Contracting State from the performance of professional services in an independent capacity, or other independent activities, in the other Contracting State is exempt from tax in that other State unless 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, in which case the income derived from the individual's activities performed in that other State may be taxed in that other State. The State of residence may tax in either case under subparagraph 1(b) of the Protocol. In addition, under that subparagraph of the Protocol, if the individual is a Portuguese 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 2 of Article 25 (Relief from Double Taxation).

Paragraph 13 of the Protocol provides that the term "fixed base" used in paragraph 1 of Article 15 (Independent Personal Services) shall be interpreted according to paragraphs 3 and 4 of the Commentary on Article 14 (Independent Personal Services) of the 1992 OECD Model and of any guidelines that, for the application of such term, may be developed by the OECD in the future. These paragraphs explain that the meaning of "fixed base" is analogous to that of the term "permanent establishment." Therefore, 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.

Paragraph 2 of Article 15 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, which is derived from the OECD Model and routinely included in U.S. treaties, 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. However, the taxation of income from the types of independent services that are covered by Articles 18 through 23 is governed by the provisions of those articles.

Article 16. 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 in the other Contracting State as an employee. However, the more specific rules of Articles 18 (Directors' Fees), 19 (Artistes and Sportsmen), 20 (Pensions, Annuities, Alimony, and Child Support), 21 (Government Service), 22 (Teachers and Researchers) and 23 (Students and Trainees) apply in the case of employment income described in one of these articles. Thus, even though the Contracting State in which employment income has its source generally has the right to tax such income under Article 16, it may not have the right to tax a particular type of income under the Convention if that right is limited by one of the aforementioned articles. Similarly, though a source State may have no general right of taxation under Article 16 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 1, remuneration derived by an employee who is a resident of a Contracting State may be taxed by his State of residence. However, to the extent that the remuneration is derived from an employment exercised (i.e., the performance of services) in the other Contracting State, the remuneration also may be taxed by that other State unless the conditions specified in paragraph 2 are satisfied.

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 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 that begins or ends in the taxable year concerned; (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that State; and (c) the remuneration is not borne 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, neither condition (b) nor condition (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. 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 or lecturers, 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 or a person, such as an entertainer who visits the ship only temporarily during stopovers, is not covered by this paragraph.

If a U.S. citizen who is resident in Portugal performs dependent services in the United States and meets the conditions of paragraph 2, or is a crew member on a Portuguese 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 subparagraph 1(b) of the Protocol, subject to the special foreign tax credit rules of paragraph 2 of Article 25 (Relief from Double Taxation).

Article 17. LIMITATION ON BENEFITS

Article 17 addresses the problem of "treaty shopping" by limiting the source basis tax benefits of the Convention to those residents of the other Contracting State that are either individuals or governmental entities or have a substantial business nexus with or a significant business purpose for residing in the other Contracting State. In a typical case of treaty shopping, 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 treaty benefits with respect to that income. Article 17 limits the abuse of the Convention by limiting the benefits of the Convention to those persons whose residence in a Contracting State is not considered to have been motivated by the existence of the Convention. Absent Article 17, the entity generally would be entitled to benefits under the treaty as a resident of a Contracting State, although the entity might be denied those benefits as a result of limitations (e.g., business purpose,

substance-over-form, step transaction, or conduit principles) applicable to the transaction or arrangement under the domestic law of the source State. Article 17 and the anti-abuse provisions of domestic law complement each other, as Article 17 generally determines whether a person has a sufficient nexus to the Contracting State to be entitled to benefits for treaty purposes, while domestic anti-abuse provisions determine whether a particular transaction should be recast in accordance with the substance of the transaction.

Article 17 follows the basic structure of the limitation on benefits articles in other recent treaties, such as the one with Germany. 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. Paragraph 2 provides a test whereby other residents may be granted benefits with respect to certain items of income. Paragraph 3 provides that benefits also may be granted to a person not entitled to benefits under the tests of paragraph 1 or 2, if the competent authority of the source State determines that it is appropriate to provide benefits in that case. Paragraph 4 defines the term "recognized securities exchange" as used in subparagraph 1(c). Paragraph 5 defines the term "gross income" as used in subparagraph 1(e)(ii). Paragraph 6 provides a special rule with respect to tax-free zones.

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, local authorities, or wholly-owned institutions or organizations (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 of the income be a resident of a Contracting State.

The third category, described in subparagraph 1(c), consists of companies in whose principal class of shares there is substantial and regular trading on a recognized securities exchange (as defined in paragraph 4) and companies more than 50 percent of each class of whose shares are owned either by companies that are residents of either Contracting State, whose principal class of shares are so traded, or by persons referred to in subparagraph 1(b).

The fourth category, described in subparagraph 1(d), includes tax-exempt organizations, including not-for-profit

organizations, private foundations, pension trusts, and other organizations and arrangements, described in subparagraph 3(b) of the Protocol, provided that more than half of the beneficiaries, members, or participants, if any, in such organization, trust, or arrangement are residents of that Contracting State who are entitled under this Article to benefits of the Convention.

The fifth category, described in subparagraph 1(e) 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 the vote and value of each class of its shares) be ultimately beneficially owned by persons who are themselves entitled to benefits under the other tests of paragraph 1 or who are U.S. citizens. The "base erosion" test requires that less than 50 percent of the person's gross income (as defined in paragraph 5) be used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not entitled to benefits under the other tests of paragraph 1 or are not U.S. citizens.

The rationale for the two-part test of subparagraph 1(e) 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 other qualified persons. It is also necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or other qualified persons. For example, a third-country resident could lend funds to a Portuguese-owned Portuguese corporation to be reloaned to the United States. The U.S. source interest income of the Portuguese corporation would be subject to a reduced U.S. withholding tax under Article 11 (Interest) of the Convention. While the Portuguese corporation would be subject to Portuguese 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 Portugal and the third country, that interest were exempt from Portuguese tax, the U.S. treaty benefit with respect to the U.S. source interest income would have flowed to the third-country resident.

Paragraph 2 provides that a person resident in one of the Contracting States may be entitled to benefits with respect to certain items of income derived from the other State if it is engaged in the active conduct of a trade or business in its State of residence and satisfies certain conditions. 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, or is incidental to, the trade or business conducted in the State of residence and the trade or business is substantial in relation to the income-producing activity. This determination is made separately for each item of income derived from the other State.

The Convention does not define the term "substantial." As in the case of other recent Conventions, it is understood that it is not necessary that the activity in the State of residence be as large as the activity in the other State in order to be considered substantial. It must, however, represent more than a de minimis percentage of the activity in the other State, whether measured in terms of income, assets, or other similar measures. This requirement is intended to prevent the following type of abuse. If, for example, a third-country resident wants to acquire a U.S. company that manufactures televisions sets for worldwide markets, but the country of residence of the investor has no tax treaty with the United States, any dividends generated by the investment would be subject to a U.S. withholding tax of 30 percent. Absent a substantiality requirement, the investor could set up a Portuguese corporation that would operate a small outlet in Portugal to sell television sets manufactured by the company, and, in fact, sell a few sets per year and earn a very small amount of income. That Portuguese corporation could then acquire the U.S. manufacturer with capital provided by the third-country resident and produce a very large number of sets for sale in several countries, generating a much larger amount of income. It might attempt to argue that the U.S. source income is generated from business activities in the United States that are related to the television sales activity of the Portuguese parent, and that, therefore, the dividend income should be subject to a U.S. tax of 10 percent. In this example, however, the substantiality requirement would not be met, and the dividends would remain subject to withholding in the United States at a rate of 30 percent.

It is intended that the provisions of paragraphs 1 and 2 will be self-executing. Unlike the provisions of paragraph 3, discussed below, a claim of benefits under paragraph 1 or 2 does not require advance competent authority ruling or approval. The tax authorities may, of course, determine on review that the taxpayer has improperly interpreted these paragraphs and is not entitled to the benefits claimed.

Paragraph 3 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 paragraphs 1 or 2 (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 4 defines the term "recognized securities exchange" as used in subparagraph 1(c). 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 Portugal, the term means the Lisbon and Oporto Stock Exchanges. The term "recognized securities exchange" also includes any other stock exchanges that may be agreed upon by the competent authorities.

Paragraph 5 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" is defined to mean 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.

Paragraph 6 provides that, notwithstanding the provisions of paragraphs 1 through 5, the benefits of this Convention shall not be allowed to any person that is entitled to income tax benefits under the provisions of the legislation and other measures relating to the tax-free zones (zonas francas) of Madeira and Santa Maria Island, or to benefits similar to those provided with respect to such tax-free zones that are made available under any legislation or other measure adopted by either Contracting State after the date of signature of this Convention. For example, suppose a Portuguese bank located in Lisbon, whose shares are publicly traded on the Lisbon Stock Exchange, establishes a wholly owned subsidiary in Madeira's International Business Centre. In this case, the bank in Lisbon is entitled to treaty benefits under subparagraph 1(c)(i) of Article 17 (Limitation of Benefits) because there is substantial and regular trading of its shares on a recognized securities exchange. Although its wholly-owned Madeira subsidiary passes the requirements for benefits laid out in subparagraph 1(c)(ii) of Article 17, the Madeira subsidiary is not entitled to benefits under the Convention because it is entitled to the benefits available to financial institutions located in Madeira's International Business Center, and paragraph 6 of Article 17 applies "notwithstanding the provisions of paragraphs 1 through 5."

Paragraph 6 further provides that the competent authorities shall notify each other of any future legislation or measure providing benefits similar to those of the tax-free zones of

Madeira and Santa Maria Island and shall consult as to whether such benefits are similar.

In order to implement paragraph 6 appropriately, it is essential that both countries be able to exchange relevant information to distinguish operations in these tax-free zones from other operations in Portugal or the United States that are entitled to the benefits of this Convention. In this connection, see the discussion of Article 28 (Exchange of Information), below.

Article 18. 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 outside of that other Contracting 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 an outside (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 former U.S. Model, which treated 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 preferred Portuguese position is reflected in the OECD Model, in which a resident of one Contracting State who is a director of a company 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 18 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 outside the other Contracting State.

This Article is subject to the "saving clause" of subparagraph 1(b) of the Protocol. Thus, if a U.S. citizen who is a Portuguese 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 19. ARTISTES AND SPORTSMEN

Article 19 addresses the taxation in a Contracting State of artistes (i.e., performing artists and entertainers) and sportsmen 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 sportsman who performs services on his own behalf and to that of one who performs his services on behalf of another person, either as an employee of that person or pursuant to any other arrangement. This Article applies, however, only with respect to the income of performing artists and sportsmen. Others involved in a performance or athletic event, such as producers, technicians, managers, and coaches, remain subject to the provisions of Article 15 or 16, as the case may be.

Paragraph 1 describes the circumstances in which a Contracting State may tax the performance income of an entertainer or sportsman who is a resident of the other Contracting State. Income derived by a resident of a Contracting State from his personal activities as an entertainer or sportsman exercised in the other Contracting State may be taxed in that other State if the amount of the compensation derived by the individual exceeds $10,000 (or its equivalent in Portuguese escudos) for the taxable year concerned. The $10,000 includes expenses reimbursed to the individual or borne on his behalf. If the compensation exceeds $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 with no dollar or time threshold. The United States introduces the dollar threshold test to distinguish between two groups of entertainers and sportsmen--those who are paid large sums of money for 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 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) and 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. An entertainer or sportsman who receives less than the $10,000 threshold amount, and who is, therefore, not affected by this Article, may nevertheless be subject to tax in the host country under Article 15 or 16 if the tests for taxability under those Articles are met. For example, if an entertainer who is an independent contractor earns only $9,000 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 15.

Paragraph 2 is intended to deal with the potential for abuse when income from a performance by an entertainer or sportsman does not accrue to the performer himself, but to another person. 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 on the person providing the services of the entertainer or sportsman. This paragraph does not affect the rules of paragraph 1, which apply to the entertainer or sportsman himself. The income taxable by virtue of paragraph 2 to the person providing the performer's services is reduced to the extent of salary payments to the performer, which are treated under paragraph 1.

For purposes of paragraph 2, income is deemed to accrue to another person (i.e., the person providing the services of the entertainer or sportsman) if that other person has control over, or the right to receive, gross income in respect of the services of the entertainer or sportsman. 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 sportsman, nor any persons related to him, participate directly or indirectly in the profits of the person providing his services. This exception for non-abusive cases to the paragraph 2 override of the Articles 7 and 15 protection of persons providing the services of entertainers and sportsman is not found in the OECD Model.

Paragraph 3 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 sportsman 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 sportsman may tax his

income from the performances. A similar exception is provided in some other recent U.S. treaties.

This Article is subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol. Thus, if an entertainer or sportsman who is a resident of Portugal 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 2 of Article 25 (Relief from Double Taxation).

Article 20. PENSIONS, ANNUITIES, ALIMONY, AND CHILD SUPPORT

Article 20 provides rules concerning the taxation of pensions, social security payments, annuities, alimony, and child support. However, the taxation of pensions in respect of governmental services rendered to a Contracting State is covered by the provisions of Article 21 (Governmental Service).

Paragraph 1(a) grants each Contracting State an exclusive taxing right with respect to pensions and other similar remuneration paid to its residents in consideration of past employment, regardless of where the past employment occurred. Paragraph 1(b) provides that social security payments and other public pensions paid to a resident of a Contracting State or a citizen of the United States by the other Contracting State may be taxed in that other State. This rule includes railroad retirement benefits provided for in the Railroad Retirement Act of 1974. Social security payments may be taxable in both Contracting States, with the State of the recipient's residence allowing relief from double taxation under the provisions of Article 25 (Relief from Double Taxation) for any taxes imposed by the Contracting State in which such payments arise.

Paragraph 2 grants an exclusive taxing right with respect to annuities beneficially derived by a resident of a Contracting State. The term "annuities" is defined to mean a stated sum paid periodically at stated times during a specified time period, under an obligation to make the payments in return for adequate and full consideration (other than for services rendered). Payments for services rendered are either employment income or income from the performance of independent personal services.

Paragraph 3 provides that alimony paid to a resident of a Contracting State is taxable only in that State and only to the extent that it is taxable under the domestic law of that State. The term "alimony" is broadly defined and intended to include all periodic payments legally required to be paid as a result of a divorce or separation (other than child support payments). Thus, if a divorced United States resident receives alimony payments from a former spouse resident in Portugal, Portugal may not

impose tax on those payments. However, such payments are taxable to the recipient under U.S. domestic law.

Paragraph 4 provides that child support payments made by a resident of one Contracting State to a resident of the other Contracting State may not be taxed by the other Contracting State. As with alimony, child support payments are broadly defined and are intended to include all periodic payments legally required to be paid for the support of minor children as a result of divorce or separation. By prohibiting the State of residence of the recipient from taxing such payments, the Convention ensures that the full amount received is available for the support of the minor children.

With the exception of paragraph 4, Article 20 is subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol, so that, in general, the United States may tax its citizens and residents on pensions, annuities, and alimony without regard to any restriction in Article 20. However, by virtue of paragraph 1(c) of the Protocol, paragraph 4 of Article 20 is not subject to the saving clause. Thus, domestic law cannot overrule the exemption provided for in paragraph 4 from tax for child support payments.

Article 21. GOVERNMENT SERVICE

Article 21 applies to remuneration paid by a Contracting State (or political subdivision or local authority thereof) in respect of services rendered to that State (or political subdivision or local authority). Paragraph 1 applies to remuneration, other than pensions, for governmental service, and paragraph 2 applies to pensions arising from such governmental service.

Paragraph 1(a) grants an exclusive taxing right for remuneration in respect of governmental service to the Contracting State (or political subdivision or local authority thereof) to which such services are rendered, regardless of who renders such services or where such services are rendered.

Paragraph 1(b) provides an exception to paragraph 1(a). It grants an exclusive taxing right for remuneration for governmental services to the State in which such services are rendered, provided that the recipient is a resident of that State and is either a national of that State or did not become a resident solely for the purpose of rendering the services. Thus, if a Portuguese resident renders services to the U.S. Government in Portugal, Portugal is granted the exclusive right to tax such services if the recipient is either a Portuguese national or did not become a Portuguese resident solely for the purpose of providing such services.

Paragraph 2(a) grants an exclusive taxing right for any pension paid in consideration for past governmental services to the Contracting State (or political subdivision or local authority thereof) to which such services were rendered. Paragraph 2(b) provides an exception to paragraph 2(a) and grants an exclusive taxing right for such pensions to the other Contracting State if the recipient is both a resident and a national thereof. Thus, the United States is granted the exclusive right to tax a U.S. national who retires to Portugal and receives a pension resulting from services rendered to the U.S. Government.

Under paragraph 3, payments for (and subsequent pensions arising from) services that are rendered in connection with a business carried on by a Contracting State or a political subdivision or local authority thereof are, as appropriate, dealt with under Article 15 (Independent Personal Services), 16 (Dependent Personal Services), 18 (Directors' Fees), 19 (Artistes and Sportsmen), or 20 (Pensions, Annuities, Alimony, and Child Support). It is understood that determinations of whether remuneration is for services (1) rendered to a Contracting State (or political subdivision or local authority thereof) or (2) rendered in connection with a business carried on by a governmental agency or authority is to be made by reference to the laws of the State in which the income arises.

Article 21 is subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol, as modified by subparagraph 1(c) of the Protocol. With respect to the United States, the modified saving clause applies to U.S. citizens and persons having immigrant status in the United States ("green card" holders). Thus, the provisions of the Article that would grant exclusive taxing rights to Portugal are overridden by the saving clause if the individuals are U.S. citizens or green card holders.

Article 22. TEACHERS AND RESEARCHERS

Paragraph 1 of the Article deals with visiting professors, teachers, and researchers. Paragraph 1 provides that if a professor, teacher, or researcher who is a resident of one Contracting State visits the other Contracting State for the purpose of teaching or conducting research at an accredited educational or research institution, he will be exempt from tax in both Contracting States on his compensation for such teaching or research for a period not exceeding two years. An individual may claim the benefits of paragraph 1 only once.

For the exemption of paragraph 1 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 subparagraph 1(b) of the Protocol. Thus, a Portuguese student, teacher, 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). The benefits of this Article are not available to a U.S. citizen or "green card" holder for U.S. tax purposes. However, Code section 911 generally exempts the first $70,000 of foreign earned income of a U.S. citizen or resident who spends a specified period of time in one or more foreign countries.

ARTICLE 23. STUDENTS AND TRAINEES

Paragraph 1 of Article 23 provides that a resident of a Contracting State who visits the other Contracting State for the primary purpose of studying at an accredited educational institution, securing training in a professional specialty, or studying or doing research as a recipient of a grant from a tax-exempt organization shall be exempt from taxation in that Contracting State with respect to certain items of income during such period of study, research, or training. Paragraph 1(b) defines those exempt items of income as: (1) payments from abroad for maintenance, education, study, research, or training; (2) grants, allowances, or awards from a governmental, religious, charitable, scientific, literary, or educational institution funding the research or studies; and (3) income from personal services performed in that other Contracting State to the extent of $5,000 (or the equivalent in Portuguese escudos) per taxable year. The exemptions provided in paragraph 1 are available to the visiting student or trainee for a period not exceeding five years from the beginning of the visit.

The second paragraph of the Article provides an exemption for residents of a Contracting State who are employed by, or under contract with, a resident of the same Contracting State and who temporarily visit the other Contracting State for the purpose of studying at an accredited educational institution or acquiring technical, professional, or business training or experience in that other Contracting State, provided such training is from a person other than the employer or contractor. Such student or trainee is exempt from taxation in the other Contracting State for a period of twelve consecutive months on personal services income to the extent of $8,000 (or the equivalent in Portuguese escudos) during that period.

The Article denies its exemptions, as does paragraph 2 of Article 22 (Teachers and Researchers), to income from research if such research is undertaken primarily for the private benefit of a specific person or persons. For example, personal service income arising from research at a corporate research facility would, in general, not qualify as exempt income.

The benefits conferred by the other Contracting State under Article 23 are subject to the provisions of the "saving clause" in subparagraph 1(b) of the Protocol, as modified by subparagraph 1(c) of the Protocol. With respect to the United States, the modified saving clause applies to U.S. citizens and persons having immigrant status in the United States ("green card" holders). Thus, the provisions of paragraph 1 that would exempt a Portuguese resident from taxation as a student in the United States are overridden by the saving clause if that student is a U.S. citizen or green card holder. On the other hand, if a student who is not a citizen or a green card holder acquires residence in the United States for tax purposes during that period of study or training, he will be exempt from tax in the United States on those items of income.

ARTICLE 24. OTHER INCOME

Paragraph 1 of Article 24 provides for exclusive residence State taxation of items of income that are not dealt with in the foregoing Articles of the Convention, unless the income arises in the other Contracting State. If the income arises in the other State, that other State may also tax it. This rule applies, for example, to prizes, awards, or gifts, and to income from third States.

Paragraph 2 provides that, if the beneficial owner of such other income carries on business in the other Contracting State through a permanent establishment or fixed base situated therein and the income is attributable to such permanent establishment or fixed base, that other income is taxable in that other State in accordance with the provisions of Article 7 (Business Profits) or 15 (Independent Personal Services), rather than under the provisions of paragraph 1. Thus, for example, income of a U.S. resident that arises in a third country but is attributable to a permanent establishment of such person in Portugal may be taxed by Portugal under the provisions of Article 7.

However, paragraph 2 does not provide an exception to the exclusive taxing right granted in paragraph 1 to the state of residence with respect to income from real property. Thus, for example, income derived from real property located in a third country is taxable under this Convention only in the Contracting State of which the recipient (beneficial owner) is a resident, even if the recipient has a permanent establishment (or fixed base) in the other Contracting State and that real property forms

part of the business property of that permanent establishment or fixed base.

Article 24 is subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol so that, in general, the United States may tax "other income" of U.S. residents and citizens without regard to the Convention. Specifically, this means that, irrespective of the exclusive right to tax third country income granted to the state of residence in paragraph 1, the United States also may tax such income received by a resident of Portugal if that resident is a U.S. citizen, subject, however, to the special foreign tax credit provisions of paragraph 2 of Article 25 (Relief from Double Taxation).

Article 25. 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. domestic law in effect for the taxable year concerned.

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)). However, nothing in the Convention would prevent the limitation of the U.S. credit from being applied on a per-country or overall basis or some variation thereof, if U.S. domestic law so provided. 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 2 provides an exception to the general rule of paragraph 1 for the tax treatment of U.S. citizens resident in Portugal. Under this paragraph, income that may be taxed by the United States solely by reason of citizenship in accordance with the "saving clause" of subparagraph 1(b) of the Protocol shall be treated as having its source in Portugal 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 Portugal under the

provisions of the Convention on U.S. citizens resident in Portugal. In no case, however, will this provision apply 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 that would be imposed if the individual were not a resident or citizen of the United States.

As an example of the application of paragraph 2, consider a U.S. citizen resident in Portugal 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 U.S. tax on portfolio dividends paid to residents of Portugal who are not U.S. citizens is limited to 15 percent ($30 in this case). Suppose Portugal taxes that income of its resident at 40 percent ($80) and grants, in accordance with the provisions of its domestic law and paragraph 2 of this Article, a credit for the $30 of U.S. tax imposed on the basis of source only. The net Portuguese tax would be $50 and the combined U.S. and Portuguese tax $106. Thus, the total tax would be higher than the total tax in either of the two countries, indicating some double taxation. Under paragraph 2, the United States agrees to resource enough of that dividend income to avoid double taxation, but not 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.

By reason of subparagraph 1(c)(i) of the Protocol, Article 25 is not subject to the provisions of the "saving clause" of subparagraph 1(b) of the Protocol. Thus, the saving clause cannot be used to deny a Portuguese 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.

Subparagraph 2(a) provides that Portugal shall provide a "deduction from tax," i.e., a credit, for taxes paid to the United States by a Portuguese resident. The credit is limited, however, to the amount of income tax that would otherwise be owed to Portugal on the income that may be taxed in the United States.

Portuguese domestic law does not give a credit similar to the U.S. credit for taxes deemed paid under Code section 902. However, subparagraph 3(b) provides the same 95-percent dividends received deduction for dividends received by a Portuguese company from a U.S. company that Portugal provides domestically for dividends received by a Portuguese company from another Portuguese company. As a practical matter, this eliminates double taxation of such profits.

Subparagraph 3(c) provides that where, in accordance with any provision of the Convention, income derived by a resident of Portugal is exempt from tax in Portugal, Portugal may, nevertheless, in calculating the amount of tax on the remaining income of such resident, take into account the exempted income. The portion of tax forgiven is thus calculated at the average tax rate, not at either the top or bottom bracket rate.

Article 26. NON-DISCRIMINATION

This Article prohibits the discriminatory taxation by one Contracting State of nationals, enterprises, and residents of the other Contracting State.

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 Portugal as a Portuguese 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 Portugal or a third country, is not in the same circumstances as a national of Portugal 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 Portuguese national is subject to U.S. tax only on U.S. source income and limited types of foreign source income.

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 State than an enterprise of that first 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, or deductions that it grants to its own residents on account of their civil status or family responsibilities. Thus, in assessing income tax on the profits attributable to a U.S. permanent establishment of a Portuguese enterprise owned by an individual resident in Portugal, the United States is not obligated to allow to the Portuguese resident the personal allowances for himself and his family that would be allowed 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 Portuguese 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. However, it is understood that this distinction is not a form of discrimination within the meaning of paragraph 2 of the Article, 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 is over-withheld, the partner can, as in other cases of over-withholding, file for a refund.

Paragraph 3 of the Article specifies that no provision of the Article will prevent either Contracting State from imposing the branch tax described in paragraph 1 of Article 12 (Branch Tax).

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 other Contracting State, the first 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 State. An exception to this rule is provided for cases where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 8 of Article 11 (Interest), or paragraph 6 of Article 13 (Royalties) apply, because all of these provisions permit the denial of deductions in certain circumstances in respect to excessive (non-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 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 requirements that it imposes on similar resident companies owned by residents of the first State. 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 6 provides that, notwithstanding the list of taxes covered by the Convention in Article 2 (Taxes Covered), the nondiscrimination provisions of this Article apply 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 subparagraph 1(b) of the Protocol does not apply to this Article, by virtue of the exceptions in subparagraph 1(c) of the Protocol. Thus, for example, a U.S. citizen who is resident in Portugal may claim U.S. benefits under this Article.

Article 27. 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(i) 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 fully 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 subparagraph 1(a)(i) of the Protocol, 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 interpretive issues under the Convention, including those regarding the characterization of items of income or of persons, the application of source rules to particular items of income, the meaning of a term, and the application of penalties, fines and interest. Agreements reached by the competent authorities under this paragraph need not conform to the domestic 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, with respect to types of 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 Portugal. 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, rather than through diplomatic channels, for these purposes.

The benefits of this Article are also available to residents or citizens of either Contracting State under subparagraph 1(c)(i) of the Protocol. Thus, rules, definitions, procedures, and other matters 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 agreements 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 28. 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 Portugal 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 a 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 (Personal 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 Portugal 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 Contracting State. Nor is a State obligated to supply information not obtainable under the laws or administrative practice of either State. Thus, there is no obligation to furnish information 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. However, it is understood that bank records will be made available to the same extent obtainable for enforcing domestic tax laws, including requests for court orders where the taxpayer does not voluntarily comply. Paragraph 14 of the Protocol confirms that records of financial institutions, including records relating to third parties, are among the types of records that may be exchanged.

A Contracting State may, at its discretion, subject to the limitations of paragraph 2 and its domestic 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 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 unedited original documents), so that the information can be used in the judicial proceedings of the requesting State. The requested State must 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.

This Article is particularly important for implementing paragraph 6 of Article 17 (Limitation of Benefits), the provision that denies benefits under the Convention to persons entitled to the benefits of tax-free zones. Since the tax-free zones of Madeira and Santa Maria Island are within the Portuguese Republic, it is essential that the United States be able to obtain the information necessary to distinguish between income associated with entities that are entitled to treaty benefits and income associated with entities that are not entitled to treaty benefits. In this regard, it is often particularly difficult to make such distinctions for financial institutions. Portugal has assured the United States that it will use the same measures in responding to U.S. requests that it is able to use for its own internal purposes. This commitment extends to requests to Portuguese courts, if necessary, that a bank be compelled to provide requested information. Information supplied by Portugal suggests that when the Portuguese authorities ask their courts to obtain necessary information from Portuguese taxpayers, the courts provide timely, positive responses.

Article 29. 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 1(c)(ii) of the Protocol.)

Article 30. ENTRY INTO FORCE

This Article provides the rules for bringing the Convention into force and giving effect to its provisions. Paragraph 1 provides that the Convention is subject to ratification by each

Contracting State, and that the instruments of ratification shall be exchanged as soon as possible.

Paragraph 2 provides that the Convention will enter into force on the date on which instruments of ratification are exchanged. Subparagraph 2(a) provides that the Convention will have effect with respect to taxes withheld at source for amounts paid or credited on or after the first day of January following the date of entry into force. For example, if the Convention were to enter into force on July 1, 1995, the withholding rates on dividends, interest and royalties would be reduced (or eliminated) for amounts paid on or after January 1, 1996. For all other taxes, the Convention will have effect for any taxable year beginning on or after January 1 of the year following the year in which the Convention enters into force, (in this example, January 1, 1996).

Article 31. 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 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 January 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 thereafter, since the notice period must last at least six months.

TREASURY DEPARTMENT
TECHNICAL EXPLANATION OF THE CONVENTION
BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA
AND THE GOVERNMENT OF THE FRENCH REPUBLIC FOR
THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION
OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME
AND CAPITAL SIGNED AT PARIS ON AUGUST 31, 1994

INTRODUCTION

This is a technical explanation of the Convention and accompanying diplomatic notes between the United States and the French Republic signed on August 31, 1994 (the "Convention"). References are made to the Convention between the United States and the French Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and Property, signed on July 28, 1967, as amended by Protocols signed in 1970, 1978, 1984, and 1988 (the "1967 Convention"). The Convention replaces the 1967 Convention.

Negotiations took into account the U.S. Treasury Department's current tax treaty policy, the Model Double Taxation Convention on Income and on Capital published by the Organization for Economic Cooperation and Development in 1992 (the "OECD Model"), and recent tax treaties concluded by 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. References in the technical explanation to "he" or "his" should be read to mean "he" or "she" or "his" or "her."

ARTICLE 1. PERSONAL SCOPE

The Convention follows U.S. and OECD practice by inserting an article referring to the scope of the Convention. Article 1 provides that the Convention is applicable only to residents of the United States or France, except where the Convention otherwise provides. Article 4 (Resident) sets forth rules for determining whether a person is a resident of a Contracting State that govern for all purposes of the Convention. Residents of a Contracting State are not, however, automatically entitled to benefits under the Convention; they must also satisfy the requirements of Article 30 (Limitation on Benefits of the Convention).

Certain provisions of the Convention are applicable by their terms to persons who may not be residents of either Contracting State. For example, Article 19 (Public Remuneration) may apply to a citizen of a Contracting State who is a resident of neither, and under Article 27 (Exchange of Information), information may be exchanged with respect to residents of third states.

Provisions describing 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, are found in paragraphs 1 and 8 of Article 29 (Miscellaneous Provisions), and are discussed in connection with that Article. Provisions preserving certain taxing rights of the Contracting States under the "saving clause" are found in paragraphs 2 and 3 of Article 29 (Miscellaneous Provisions). Those provisions are discussed here, because they are an important qualification to the scope of this Article.

As in the 1967 Convention (see paragraph 4 of Article 22 (General Rules of Taxation)), the saving clause in this Convention is, at France's request, unilateral, applying only for United States tax purposes. Under paragraph 2 of Article 29 (Miscellaneous Provisions), the United States reserves its right, except as provided in paragraph 3 of Article 29, to tax U.S. residents and citizens as provided in the Internal Revenue Code (the "Code"), notwithstanding the provisions of the Convention. If, for example, a French 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 French resident is also a citizen of the United States, the saving clause permits the United States to include that income 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 France, see paragraph 1(b) of Article 24 (Relief from Double Taxation).)

For the purpose of the saving clause, residence 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 and is also a resident of France under French domestic law, and the rules of Article 4 determine that he is a resident of France, he will be entitled to U.S. benefits under this Convention. The saving clause would not permit the United States to apply its domestic law to that person if it is inconsistent with the Convention.

Under paragraph 2 of Article 29 (Miscellaneous Provisions), the United States also reserves its right to tax former U.S. citizens, whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income tax, for ten years following the loss of citizenship. Such a former citizen is taxable in accordance with the provisions of section 877 of the Code for ten years following the loss of citizenship. This provision is somewhat narrower than in some other U.S. income tax treaties in referring only to the avoidance of income tax and not all taxes; it is similar in that respect, however, to the recent treaties concluded with Germany and the Netherlands.

Subparagraph 3(a) of Article 29 (Miscellaneous Provisions) sets forth certain exceptions to the saving clause, to prevent it from applying where it would contravene provisions of the Convention that are intended to extend U.S. benefits to U.S. citizens and residents. Subparagraph (a) lists certain provisions of the Convention that are applicable to all U.S. citizens and residents, despite the general saving clause rule of paragraph 2. Those provisions provide the following benefits: (1) Paragraph 2 of Article 9 (Associated Enterprises) grants a corresponding adjustment in certain circumstances and explicitly permits the override of the statute of limitations for the purpose of refunding tax under such a corresponding adjustment. (2) Subparagraph 3(a) of Article 13 (Capital Gains) limits the taxes imposed at source and residence on gain derived by a resident of one Contracting State from alienating business property of a permanent establishment or fixed base in the other State. This exception preserves the benefit provided by the State of residence. (3) Subparagraph 1(b) of Article 18 (Pensions) provides that only the paying State may tax social security benefits paid to a resident of the other State. This exception to the saving clause prohibits the United States from taxing French social security payments received by its residents even if they would otherwise be taxable under the Code. (4) Article 24 (Relief from Double Taxation) confirms the benefit of a foreign tax credit to U.S. citizens and residents. (5) Article 25 (Non-Discrimination) preserves the benefits of non-discriminatory taxation for an individual who is either a dual national or a French national and a U.S. resident, and for an enterprise that is a U.S. resident and is owned or controlled by French residents. (6) Article 26 (Mutual Agreement Procedure) may

confer benefits on U.S. citizens and residents. For example, it provides that the statute of limitations may be waived for refunds and that the competent authorities are permitted to use a definition of a term that differs from the Code definition. As with the foreign tax credit, these benefits are intended to be granted by a Contracting State to its citizens and residents.

Subparagraph 3(b) of Article 29 (Miscellaneous Provisions) provides a different set of exceptions to the saving clause. The benefits referred to are granted to certain temporary U.S. residents, but not to U.S. citizens or individuals with immigrant status. The United States will continue to grant these benefits to non-U.S. citizens who come to the United States from France 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), even if these benefits would not be allowed under the Code. The benefits preserved by this paragraph are the exemptions for the following items of income: government service salaries and pensions under Article 19 (Public Remuneration); certain income of visiting teachers and researchers under Article 20 (Teachers and Researchers); certain income of students and trainees under Article 21 (Students and Trainees); and the income of diplomatic and consular officers under Article 31 (Diplomatic and Consular Officers).

Article 2. TAXES COVERED

This Article identifies the U.S. and French taxes to which the Convention generally applies. These are referred to collectively in the Convention as "United States tax" and "French tax," respectively. The corresponding article in the 1967 Convention has been updated to reflect the currently applicable tax laws of the two countries.

In the case of the United States, as indicated in subparagraph 1(a), the covered taxes are the Federal income taxes imposed by the Code, together with the excise taxes imposed on insurance premiums paid to foreign insurers (under Code section 4371) and the excise taxes with respect to the investment income of private foundations (under Code sections 4940 et seq.). With respect to the excise tax on insurance premiums, the Convention applies 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 income tax convention, to exemption from the tax.

Covering the U.S. insurance premiums excise tax effectively exempts from the tax certain premiums received by companies resident in France, subject to the anti-conduit rule for reinsurance described above. Under the Code, the tax is imposed only on premiums that are not attributable to an office or other fixed place of business in the United States or that are exempt

by treaty from net-basis U.S. income tax because they are not attributable to a U.S. permanent establishment. Since the Convention covers the tax, and Article 7 (Business Profits) precludes the United States from subjecting the income of a French enterprise to any covered tax if that income is not attributable to a permanent establishment that the enterprise has in the United States, the tax is effectively waived.

The 1967 Convention, as amended by the 1978 Protocol, covered the insurance premiums excise tax in the same manner. That coverage was preserved in the new Convention only after a review of French law indicated that the income tax imposed by France on French resident insurers results in a burden that is substantial in relation to the U.S. tax on U.S. resident insurers. On the basis of this analysis, U.S. negotiators concluded that it is appropriate to continue to waive the tax in the new Convention.

The Convention does not apply to social security taxes. Those taxes are dealt with in the bilateral Social Security Totalization Agreement, which entered into force on July 1, 1988.

Nor are state and local taxes in the United States covered by the Convention, except for purposes of Article 25 (Non-Discrimination). Article 25 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.

Subparagraph 1(b) specifies the existing French taxes that are covered by the Convention. They are all taxes imposed on behalf of the State on income or capital, including the income tax, the company tax, the tax on salaries applicable to business profits or income from independent personal services, and the wealth tax.

The French tax on stock exchange transactions, covered by paragraph 5 of Article 22 (General Rules) of the 1967 Convention, is now covered by paragraph 4 of Article 29 (Miscellaneous Provisions), which also covers any such future taxes by providing that neither State shall impose a stamp or like tax on any transaction in which an order for the purchase, sale, or exchange of securities originates in one Contracting State and is executed through a stock exchange in the other Contracting State.

Paragraph 2 provides that the Convention also 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 the date of signature of the Convention (August 31, 1994). The paragraph also provides that the U.S. and French competent authorities will notify each other of changes in their taxation laws and of official published

material 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. It is substantially the same as the corresponding article in the 1967 Convention. The OECD Model language in the introduction of paragraph 1, "unless the context otherwise requires," was deleted, at the suggestion of France, as unnecessary and possibly confusing.

Some terms are not defined in the Convention. The interpretation of such terms is dealt with in paragraph 2. 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, 11, and 12, respectively.

Subparagraph 1(a) of Article 3 states that the term "Contracting State" means the United States or France, depending on the context in which the term is used.

The terms "United States" and "France" 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 term includes the states of the United States and the District of Columbia. It also includes the territorial sea adjacent to the states and any area outside that territorial sea to the extent that, under international law, the United States has sovereign rights to explore for and exploit the natural resources of the continental shelf and the waters above it. The term "France" means the French Republic (Metropolitan France and the Overseas Departments of Guadeloupe, Guyane, Martinique, and Reunion). When used geographically, the term includes the French territorial sea and any area outside that territorial sea to the extent that, under international law, France has rights to explore for and exploit the natural resources of the continental shelf and the waters above it.

Subparagraph 1(d) states that the term "person" includes an individual and a company. The definition is illustrative only. It is understood to include also a partnership and, in the case of the United States, an estate or a trust.

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.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" are defined in subparagraph 1(f) as an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State.

Subparagraph 1(g) defines the term "international traffic." The term means any transport by a ship or aircraft except when the vessel is operated solely between places within a Contracting State. The exclusion of transport solely between places within a Contracting State means, for example, that the carriage of goods or passengers solely between New York and Chicago by either a U.S. or a French 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 were a French resident (if that were possible under U.S. law), Article 8 would not require the United States to exempt the income. 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 then only on a net basis. The gross-basis U.S. tax would not apply under the circumstances described. if, however, goods or passengers were carried by a French carrier from Le Havre to New York to Chicago, with some of the goods or passengers carried only to New York, and the rest taken to Chicago, the entire transport would be international traffic.

Subparagraphs (h)(i) and (ii) define the term "competent authority" for the United States and France, respectively. 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 interpretive issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service. In France, the competent authority is the Minister in charge of the budget or his authorized representative.

Paragraph 2 provides that, in the application of the Convention by a Contracting State, any term used but not defined in the Convention will, unless the context requires otherwise, have the meaning it has under the taxation law of the Contracting State whose tax is being applied. The word "taxation" was inserted at the request of France to make clear that, if the same

term has differing definitions in different laws, it is the taxation law definition that applies. This is consistent with the U.S. position regarding interpretation of this provision. If the meaning of a term cannot be readily determined under the tax law of a Contracting State, or if there is a conflict between the tax laws of the two States that creates problems in the application of the Convention, the competent authorities may, pursuant to the provisions of Article 26 (Mutual Agreement Procedure), 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 a Contracting State for purposes of the Convention. It modernizes the definition contained in the 1967 Convention.

Determination of residence is important because, as noted in the explanation to Article 1 (Personal Scope), as a general rule, only residents of the Contracting States may claim the benefits of the Convention. The Article 4 definition of residence is used for all purposes of the Convention, including the "saving" clause of paragraph 2 of Article 29 (Miscellaneous Provisions).

The definition of residence looks first to a person's liability to tax as a resident under the respective domestic laws of the Contracting States. A person who, under those laws, is a resident of one Contracting State and not of the other need look no further. For purposes of the Convention, that person is a resident of the State of which he is a resident under domestic law. If, however, a person is resident in both Contracting States under their respective taxation laws, the "tie-breaker" rules of paragraph 3 of the Article assign one State of residence to the person.

Paragraph 1 defines a "resident of a Contracting State." This definition generally incorporates the definitions of residence in U.S. and French domestic law, by defining a resident as a person who, under the laws of a Contracting State, is subject to tax there by reason of his domicile, place of management, place of incorporation, or any other similar criterion.

Paragraph 1 specifies, however, that a person liable to tax only in respect of income from sources within a Contracting State, or, in the case of France, only in respect of capital situated in France, will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, a French consular official in the United States, who may

be subject to U.S. tax on U.S. source investment income but is not taxable in the United States on non-U.S. income, would not be considered a resident of the United States for purposes of the Convention.

Subparagraph 2(a) provides rules for determining when a U.S. citizen or a "green card" holder is to be treated by France as a U.S. resident for purposes of enjoying the benefits of the Convention. If such an individual is a resident of both the United States and France under their respective domestic laws, the tie-breaker rules of paragraph 3 of the Article (discussed below) determine a single country of residence for all purposes of the Convention. If, however, the individual is not a resident of France, but is a U.S. citizen or green card holder resident in a third country, France will treat that individual as a resident of the United States only if he has a substantial presence in the United States or if his permanent home or habitual abode is in the United States and not in the third country. In applying the "substantial presence" test for this purpose, France will apply its own 183-day standard, because French tax is at issue.

Subparagraph 2(b) clarifies that the "liable to tax" language of paragraph 1 is not meant to deny residence status, for purposes of treaty benefits, to the Government of a Contracting State or to certain organizations to which that State grants tax-exempt status. Subparagraph 2(b)(i) explicitly includes in the definition of "resident" the Governments themselves, U.S. state and local governments, local authorities, and any agency or instrumentality of those governmental bodies. Subparagraph 2(b)(ii) clarifies that pension trusts, other retirement or employee benefit organizations, and not-for-profit organizations qualify as residents if they meet the conditions specified in that subparagraph. Subparagraph 2(b)(iii) further clarifies that certain investment vehicles are residents of the Contracting State in which they are created or organized, even though the tax on the income they derive may be imposed only or primarily at the level of their shareholders, beneficiaries, or owners. Specific examples of this latter category include U.S. regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, and the French investment entities mentioned in subparagraph (iii). The competent authorities may add further investment entities to this category by mutual agreement. The provisions of subparagraphs 2(b)(i), (ii), and (iii) are clarifications of the U.S. interpretation of the language in paragraph 1. Their inclusion here does not imply a different result in U.S. income tax treaties where this language is not included.

Subparagraph 2(b)(iv) further clarifies that the definition of "resident of a Contracting State" includes a partnership or similar pass-through entity and an estate or trust, but only to

the extent that the income derived by such entity is subject to tax in that State as the income of a resident, either in the hands of the entity or in the hands of its partners, beneficiaries, or grantors. A U.S. limited liability company, for example, would be a "similar pass-through entity" for this purpose.

Differences between the U.S. and French domestic laws regarding the taxation of partnership income are responsible for several special treaty provisions. Under U.S. law, an organization taxable as a partnership is not a taxable entity. Thus, the extent to which income received by a partnership is treated as income of a resident of the United States will be determined by the residence of the partners (looking through any partnerships that are themselves partners) rather than by the residence of the partnership itself. Similarly, in France, the tax liability generally is computed at the partnership level, but the tax is imposed on the partners. The United States will, accordingly, generally look through a French partnership and determine residence at the level of the members. The United States will, therefore, give U.S. tax benefits under the Convention only to the extent the members are taxed by France as French residents. However, France may in some cases tax a "société de personnes," an economic interest group, or a European economic interest group constituted and managed in France at the entity level, independently of the residence of the partners. In such a case, the United States will determine residence at the entity level instead.

In the exchange of diplomatic notes that accompanies the treaty, the United States confirms, at France's request, that it also treats a "société de personnes," an economic interest group, or a European economic interest group constituted and managed in France and not subject to French company tax as a partnership for purposes of granting U.S. tax benefits under its tax treaties with other countries. This means that a member of such a French entity that is a resident of a third country with which the United States has an income tax treaty in effect may qualify for U.S. tax benefits under that other treaty, although the member will not receive U.S. tax benefits under this Convention. This result merely confirms the United States position on how this treaty provision should be interpreted.

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.

If, under the domestic 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 apply under paragraph 3 to determine a single State of residence for that individual. 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 nationality. If he is a national of both States or of neither, the matter will be considered by the competent authorities, who will assign a single State of residence.

Paragraph 4 addresses dual-residence issues for persons other than individuals. A corporation is treated as a resident of the United States if it is created or organized under the laws of a state of the United States. Under French law, a corporation is treated as a resident of France if it is incorporated in France or has its place of effective management ("siege social effectif") there. Dual residence, therefore, can arise if a corporation organized in the United States is managed in France. Paragraph 4 provides that, if a corporation or other person, other than an individual, is resident in both the United States and France under paragraphs 1 and 2, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention. If they are unable to reach agreement, that person shall not be considered to be a resident of either the United States or France for purposes of enjoying benefits under the Convention. Such dual residents may be treated as residents of a Contracting State for other purposes of the Convention. For example, if a dual resident corporation pays a dividend to a resident of France, 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 France, not by the dual resident corporation.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment." This definition is significant for several articles of the Convention. Under Article 7 (Business Profits), a Contracting State may not tax the business profits of a resident of the other Contracting State unless that resident has a permanent establishment in the first Contracting State. Since the term "fixed base" in Article 14 (Independent Personal Services) is understood by reference to the definition of "permanent establishment," this Article is also relevant for purposes of that Article. Articles 10, 11, and 12, respectively, provide for

reduced rates of tax at source on payments of dividends, interest, and royalties, to a resident of the other State when the income is not attributable to a permanent establishment or fixed base of the recipient in the source State. Similarly, Article 22 (Other Income) provides an exemption from source basis taxation only when the income is not attributable to a permanent establishment or fixed base in the source State.

This Article follows closely the OECD Model provisions. However, like other recent U.S. income tax conventions, it adds a rule treating drilling rigs in the same manner as construction sites.

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 examples of fixed places of business that constitute a permanent establishment. The list includes a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, and any other place of extraction of natural resources.

Paragraph 3 deals with a building site, a construction or installation project, or an installation or drilling rig or ship used to explore for or to prepare for the extraction of natural resources. The phrase "to prepare for the extraction" is meant to include development wells. Only if the site or project continues, or the drilling equipment is used, for more than twelve months does it constitute a permanent establishment.

The twelve-month test of paragraph 3 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, is 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 as a single project even if each house is constructed for a different purchaser. If the twelve-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 contains language almost identical to that in the Convention with respect to construction activities. This interpretation, therefore, conforms to the generally accepted international interpretation of the language in paragraph 3 of Article 5 of the Convention with respect to such activities. It is the U.S. position that drilling rigs, both onshore and offshore, should be treated in the same manner as

construction activities. The OECD Commentary notes that the laying of pipelines is considered a construction activity, and drilling activities perform an analogous function. The provisions of the Convention are consistent with that position.

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 activities that have a preparatory or auxiliary character for the enterprise will not constitute a permanent establishment of the enterprise. Such activities might include, for example, advertising or collecting information. Although none of these activities undertaken separately will give rise to a permanent establishment, the performance of a combination of these activities could do so. However, a combination of the enumerated activities will not give rise to a permanent establishment so long as the resulting overall activity is of a preparatory or auxiliary character. This combination rule is the same as in the OECD Model.

Paragraphs 5 and 6 specify when the use of an agent will give rise to a permanent establishment. Under paragraph 5, an enterprise will be deemed to have a permanent establishment by reason of the activities of a dependent agent 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 activities specified in paragraph 4, that would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, those activities will not give rise to a permanent establishment of the enterprise.

The Convention deletes the special rules found in paragraphs 5(b) and 7 of the existing Convention concerning dependent agents who maintain substantial equipment or receive insurance premiums in the other State. Neither of those rules is found in recent U.S. treaties or in the OECD Model treaty, and it was considered more appropriate in the new Convention to apply the general dependent agent rules in all cases.

Paragraph 6 provides that 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 or not a company is a permanent establishment of a related company is based solely on the factors described in paragraphs 1 through 6 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 from real property situated in the other Contracting State may be taxed in the State in which the property is situated. The Article does not grant an exclusive taxing right to the situs State, but assigns it the primary right. Like the OECD Model, this paragraph specifies that income from agriculture and forestry is covered by this Article.

Paragraph 2 defines the term "real property" as having the meaning that it has under the domestic law of the situs country. However, paragraph 1 defines it in any case to include property used in agriculture and forestry. In addition, paragraph 2 specifies certain classes of property that, regardless of domestic law definitions, are to be included within the meaning of the term for purposes of the Convention. The definition is similar to that in the OECD Model but adds references to options and promises to sell. The two terms overlap for purposes of U.S. law, but French law distinguishes between the two, so France preferred to specify both.

Paragraphs 3 and 4 clarify that this Article applies to income from the use in any form of real property, including leasing, and that it applies to income from the use of real property of an enterprise or in the performance of independent personal services.

This Article is not subject to the provisions of Article 7 (Business Profits) or 14 (Independent Personal Services). 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.

Paragraph 5 provides a special rule that permits either Contracting State to impose tax, in accordance with its law, on income derived by a resident of the other Contracting State from a right in any form to enjoy real property owned by a company in which the resident holds an ownership interest. Thus, for example, if a U.S. company owns real property in France and grants time-sharing rights to its shareholders with respect to that property, France may tax the imputed rental value of the use of that property to the same extent that it would do so in the case of a French resident. (Under French domestic law, an enterprise is taxed on its imputed income based on the property's rental value, but individuals are taxed only their actual income from real property.) Like paragraph 1, this provision applies independently of Articles 7 (Business Profits) and 14 (Independent Personal Services). There is no requirement that the income be attributable to a permanent establishment or fixed base in the State where the property is situated. A similar rule is included in the recent U.S. income tax treaty with Spain.

Paragraph 6 permits a resident of either Contracting State to elect to be taxed on income from real property situated in the other Contracting State on a net basis. In some cases, French domestic law provides for taxation on a net basis, or taxation net of deemed expenses, without requiring an election. In such a case, which primarily affects forestry, those domestic rules will apply. This provision is intended to permit net basis taxation in cases where it would not otherwise permitted be under domestic law.

Article 7. BUSINESS PROFITS

This Article provides rules for the taxation by a Contracting State of the business profits of an enterprise of the other Contracting State. It updates the corresponding Article in the 1967 Convention to correspond more closely to the current OECD Model.

The general rule, found in paragraph 1, is that business profits of an enterprise of one Contracting State may be taxed by the other Contracting State only if the enterprise carries on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)). Where that condition is met, the State in which the permanent establishment is situated may tax only the income of the enterprise that is attributable to the permanent establishment.

Paragraph 2 provides rules for attributing profits to a permanent establishment. A Contracting State may 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 conditions. The profits

attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, for example, items of foreign source income described in section 864(c)(4)(B) of the Code may be attributed to a U.S. permanent establishment of a French enterprise and taxed by the United States under the Convention. The limited "force of attraction" rule in Code section 864(c)(3) is not applicable under the Convention. The concept of "attributable to" in the Convention is, therefore, narrower than the concept of "effectively connected" in section 864(c) of the Code.

The computation of the business profits attributable to a permanent establishment under paragraph 2 is subject to the rules of paragraph 3 regarding deductions for expenses incurred for the purposes of earning the income. Paragraph 3 provides that, in determining the business profits of a permanent establishment, deductions shall be allowed for expenses incurred by the enterprise that are reasonably connected with such profits. Such expenses include executive and general administrative expenses. They also include interest, research and development, and other expenses incurred by the home office, to the extent that they are attributable to the permanent establishment. Deductions are to be allowed regardless of where the expenses are incurred. Each country may apply its own rules in calculating expenses "reasonably connected" with the profits of the permanent establishment, whether based on allocation or tracing; the United States, therefore, may apply the rules of Treasury Regulation section 1.882-5, where applicable. France may apply its own rules in determining deductions for French company tax, provided that they are consistent with the provisions of paragraph 3.

Paragraph 4 provides a special rule, carried over in large part from the 1967 treaty, concerning partnerships. This paragraph provides that a partner shall be considered to incur income and deductions with respect to his share of the partnership profits or losses as if each item of income or deduction were realized or incurred from the same source and in the same manner as by the partnership. However, if the partnership agreement establishes special allocations of profits or losses, those special allocations will be respected, provided that they have substantial economic effect. This rule is consistent with the treatment of partnership income under U.S. domestic law, but is to be followed by both Contracting States in determining the income or loss derived by residents of that State through a partnership. The rule applies to all partnerships, whether formed under the laws of France, a U.S. state or the District of Columbia, or another jurisdiction. It was introduced in 1979 to resolve apparent differences in the treatment of partners under U.S. and French tax laws, and has been retained to ensure that uniform treatment continues.

Paragraph 5 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 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 6 states that the business profits attributed to a permanent establishment are only those derived from its assets or activities. This clarifies the fact, as noted in connection with paragraph 2 of the Article, that the Code concept of effective connection, with its limited "force of attraction," is not incorporated into the Convention.

Paragraph 7 incorporates the rule of Code section 864(c)(6) into the Convention. It provides that any income or gain attributable to a permanent establishment during its existence is taxable in the Contracting State where the permanent establishment is or was situated, even if the payments are deferred until after the permanent establishment no longer exists. A similar rule was introduced into the 1967 Convention by the 1988 Protocol.

Paragraph 8 explains the relationship between the provisions of Article 7 and other provisions of the Convention. Where business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will take precedence. In some cases those articles will refer back to Article 7. Thus, for example, the taxation of interest generally will be determined by the rules of Article 11 (Interest). However, as provided in paragraph 4 of Article 11, if the interest is attributable to a permanent establishment, the provisions of Article 7 will apply instead.

The 1967 Convention contained a definition of the term "business profits" that specifically included income from the leasing of tangible personal property and of films and tapes. That definition has been omitted in the interest of consistency with the OECD Model. However, the result is the same. It is agreed that the leasing of tangible personal property gives rise to business profits taxable under this Article. The rental of films and tapes is now covered under Article 12 (Royalties) but gives rise to copyright royalties exempt from tax at source

except to the extent attributable to a permanent establishment or fixed base, in which case this Article or Article 14 (Independent Personal Services) applies.

This Article is subject to the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions). Thus, for example, if a citizen of the United States who is a resident of France 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 subparagraph 1(b) of Article 24 (Relief from Double Taxation), tax those profits as part of the worldwide income of the citizen, notwithstanding the provisions of this Article.

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, as that term is defined in subparagraph 1(g) of Article 3 (General Definitions).

Paragraph 1 provides that profits derived by an enterprise of a Contracting State from the operation in international traffic of ships or aircraft shall be taxable only in that Contracting State. By virtue of paragraph 8 of Article 7 (Business Profits), profits of an enterprise of a Contracting State that are dealt with in this Article are exempt from tax by the other Contracting State even if the enterprise has a permanent establishment or fixed base in that other State to which the profits are attributable.

Paragraph 2 defines the scope of income covered by this Article. It differs from the 1967 Convention in not including gains from the alienation of ships and aircraft used in international traffic. However, the same rule applies under paragraph 4 of Article 13 (Capital Gains). Subparagraph 2(a) provides that profits from the operation of ships or aircraft in international traffic include both profits from the rental of ships or aircraft on a full basis (i.e., equipped with crew and supplies) and profits from the rental of ships or aircraft on a bareboat basis (i.e., without crew and supplies) if the ships or aircraft are operated in international traffic by the lessee or if such profits are accessory to international operating income of the lessor. If the profits are accessory to international operating income, the exemption extends to income from domestic operations within the source State.

Subparagraph 2(b) provides that profits from the use, maintenance, or rental of containers and related equipment used in international traffic are covered by this Article if such profits are accessory to international operating income. Profits from container leasing that do not qualify for exemption at

source under this Article fall within the scope of Article 7 (Business Profits) or 14 (Independent Personal Services). Only income that is attributable to a permanent establishment or fixed base that the lessor has in the other Contracting State may be taxed in that other State under Article 7 or 14.

Paragraph 3 clarifies that the provisions of the preceding paragraphs apply to the share of profits derived by an enterprise of a Contracting State from participation in a pool, joint business, or international operating agency.

The 1967 Convention, as amended by the 1978 Protocol, included a limitation of benefits provision within this Article. That provision has been deleted, and shipping and air transport enterprises will be subject to the general limitation on benefits rules of Article 30 (Limitation on Benefits of the Convention).

An exchange of letters signed on the same date as the convention confirms that France will exempt U.S. enterprises engaged in the international operation of ships and aircraft from its "taxe professionnelle" in respect of such operations, as long as French enterprises similarly engaged are not subject to state income taxation in the United States in respect of such operations. This extends the French position taken in the 1984 exchange of notes under the 1967 Convention.

This Article is subject to the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions). The United States, therefore, may tax the shipping or air transport profits of a resident of France if that resident is a citizen of the United States, subject to the special foreign tax credit rules of subparagraph 1(b) of Article 24 (Relief from Double Taxation).

Article 9. ASSOCIATED ENTERPRISES

This Article incorporates into the Convention the general principles of section 482 of the Code. It provides that, when associated enterprises engage in transactions that are not at arm's length, the Contracting States may make appropriate adjustments to the taxable income of such enterprises to reflect the income with respect to such transactions that would have resulted had an arm's-length relationship existed.

Paragraph 1 deals with the case where an enterprise of a Contracting State is associated with an enterprise of the other Contracting State, and those enterprises make arrangements or impose conditions between themselves in their commercial or financial relations that differ from those that would be made between independent persons. Under those circumstances, a Contracting State may adjust the income of its resident enterprise to reflect the profits that would have been taken into account in the absence of such a relationship. The paragraph

applies when an enterprise of one Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State, or when 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 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 adjustment was appropriate, that other State is obligated to make a corresponding adjustment to the tax liability of the associated enterprise in that State. In determining such adjustments, the Contracting States will take into account the other provisions of the Convention, where relevant. For example, if the effect of a corresponding adjustment is to treat a French subsidiary corporation as having made a distribution of profits to its U.S. parent corporation, the provisions of Article 10 (Dividends) will apply and permit France to impose a 5 percent withholding tax on the deemed dividend. Such adjustments are made in accordance with the provisions of Article 26 (Mutual Agreement Procedure). Accordingly, the competent authorities may consult to resolve any differences in the application of these provisions.

If a corresponding adjustment is made under paragraph 2, it is to be implemented, pursuant to paragraph 2 of Article 26 (Mutual Agreement Procedure), notwithstanding any time limits or other procedural limitations in the law of the Contracting State making the adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because, under paragraph 1 of Article 29 (Miscellaneous Provisions), the Convention cannot provide less favorable treatment than domestic law would provide.

The saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions) does not apply to paragraph 2 of Article 9. Thus, for example, if the United States makes a corresponding adjustment that reduces the tax liability of a U.S. citizen or resident, a refund may be made even if the statute of limitations under U.S. domestic law has expired.

Article 9 of the Convention does not contain a counterpart to the paragraph 3 found in many other U.S. income tax treaties. 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 (i.e., 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 fact 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.

Article 10. DIVIDENDS

Article 10 provides rules for the taxation of dividends paid by a company that is a resident of one Contracting State to a resident of the other Contracting State. It also provides rules, in paragraph 7, for the imposition of a tax on branch profits.

Paragraph 1 preserves the right of each Contracting State to tax dividends derived by its residents from companies resident in the other Contracting State. In the case of the United States, this is consistent with the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions).

Paragraph 2 limits the right of the source State to tax dividends beneficially owned by a resident of the other Contracting State. The U.S. tax is limited to 5 percent of the gross amount of dividends paid by a U.S. company to a French company that is the direct beneficial owner of least 10 percent of the voting power of the paying company. The term "voting power" as used here has the same meaning that it has for purposes of section 902 of the Code. The French tax is limited to 5 percent of the gross amount of dividends paid by a French company to a U.S. company that is the beneficial owner, directly or indirectly, of at least 10 percent of the capital (i.e., total equity capital) of the paying company. In other cases, the source country tax is limited to 15 percent of the gross amount of the dividend.

The reason for the broader scope of the French provision, that extends the 5 percent rate to indirect owners, is that France extends its dividend tax credit ("avoir fiscal") to U.S. shareholders subject to the 15 percent rate. (See discussion of paragraph 4, below.) France has not agreed to extend that credit to U.S. shareholders who indirectly own 10 percent or more of the capital of the French company paying the dividend. However, it is willing to extend the 5 percent rate to such indirect owners.

Dividends paid by U.S. regulated investment companies ("RICs") and real estate investment trusts ("REITs") and by certain French investment companies ("sociétés d'investissement á capital variable" or "SICAVs") are not eligible for the reduced rates at source on the same basis as are dividends paid by other companies. Dividends paid by RICs and SICAVs are subject to the 15 percent rate, regardless of the percentage of voting power or capital of the paying company held by the beneficial owner of the dividend. Generally, the reduction of the 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. Because RICS, REITS, and SICAVs are generally not liable to corporate tax with respect to amounts distributed, the rate reduction from 15 to 5 percent cannot be justified by this rationale. Further, it is unlikely that a 10 percent shareholding in a RIC will constitute a 10 percent shareholding in any company from which the dividends originate. Had the French investor purchased shares directly in the U.S. company instead of through a RIC, it would typically qualify for the 15 percent rate, not for the 5 percent rate. In the case of dividends paid by a REIT, the 15 percent rate is available only to individual residents of France holding a less than 10 percent interest in the REIT. In other cases the statutory rate of 30 percent applies. As in the case of investment through a RIC, this is intended to prevent indirect investment in U.S. real property through a REIT from being treated more favorably than investment directly in such real property.

Paragraph 3 confirms that paragraph 2 does not affect the taxation of the profits out of which the dividends are paid.

Paragraph 4 extends to certain U.S. shareholders all or a portion of the dividend tax credit ("avoir fiscal") that is provided under French law to French resident shareholders. Subparagraph 4(a) provides that, where a resident of France would be entitled under French law to a tax credit in respect of dividends paid by a company that is a resident of France, the same amount of credit will be available to certain residents of the United States with respect to such dividends. The credit is, however, subject to deduction of the tax provided for in subparagraph 2(b) from the gross amount of the dividend plus the credit. Subparagraph 4(b) describes the U.S. residents eligible for this credit: individuals, other persons that are not companies, and companies that own less than 10 percent, directly or indirectly, of the capital of the French company paying the dividend. In the case of a RIC, there is a further requirement that more than 80 percent of its shareholders be U.S. citizens or residents. Subparagraph 4(d) provides that a partnership or similar pass-through entity, an estate, or a trust (other than a pension trust, REIT, or other entity described in subparagraph 2(b)(ii) or (iii) of Article 4) is eligible for the credit to the

extent that its partners or beneficiaries are eligible. In all such cases, the credit is available only to U.S. persons subject to U.S. income tax on the dividend received from the French company and the credit related to the dividend (subparagraph 4(c)).

In each of the cases mentioned in subparagraphs 4(a) through (d), the tax credit will result in a cash refund from France under its current imputation system. In 1995, the French corporation tax is imposed at 33.33 percent. The "avoir fiscal" is equal to one half of the dividend distributed. The shareholder includes the cash dividend plus the "avoir fiscal" in taxable income and credits the "avoir fiscal" against the tax due. For example, assume that a French corporation has 100 of taxable income, pays 33.33 of tax, and distributes the full 66.67 to individual U.S. shareholders. Under the Convention, the U.S. shareholders will have French dividend income of 100 (66.67 + 33.33), from which France may collect a tax of 15 percent, or 15. However, the shareholders will be entitled to a credit of 33.33 against that 15, resulting in a refund from the French Government of 18.33. Thus the cash dividend, after French tax, will be 85, 66.67 from the French corporation and 18.33 of refund of French tax. This credit provision was introduced into the 1967 Convention by the 1978 Protocol. Since that time, the French corporate tax rate has declined from 50 percent to 33.33 percent. The "avoir fiscal" has remained equal to one-half of the dividend, and thus has increased in relation to the corporate tax from 50 to 100 percent of the tax.

The Convention provides a partial dividend tax credit to certain other classes of U.S. shareholders. Subparagraph 4(e) provides U.S. residents a credit equal to 30/85 of the "avoir fiscal" available to a French resident shareholder in the case of dividends derived and beneficially owned by: (1) the United States, a state or local authority of the United States, or any agency or instrumentality of such a governmental body, from the investment of retirement assets; (2) a pension trust, retirement or employee benefit organization, or tax-exempt organization described in subparagraph (b)(ii) of Article 4 (Resident); or (3) an individual, from investments in a retirement arrangement under which either the contributions are deductible for U.S. tax purposes or U.S. tax on the accumulated earnings is deferred. The negotiators agreed that these three categories cover all investments by U.S. pension plans or other arrangements described in Code sections 401(a), 403, 408, and 457. However, the scope of subparagraph 4(e) is not limited to plans and arrangements described in one of these sections. For instance, a plan or arrangement described in Code section 414(d) will qualify for the avoir fiscal provided under subparagraph 4(e) if it satisfies the requirements of that subparagraph, even if it is not described in Code section 457. Any other plan or arrangement that satisfies the requirements of subparagraph 4(e) will be entitled to the

avoir fiscal provided under that subparagraph, even if it is not a qualified plan under U.S. domestic law.

As noted above, when a French corporation distributes a dividend of 66.67 out of 100 of pre-tax profit on which it has paid 33.33 of French corporation tax, a French shareholder reports 100 of dividend income and claims an "avoir fiscal" of 33.33. In this case, an eligible U.S. shareholder would report dividend income of 66.67 plus 11.76 (30/85 x 33.33), or 78.43. The French tax due would be 15 percent of 78.43, or 11.76, and the cash dividend after French tax would be 66.67. Thus, the tax credit fully offsets the tax otherwise due at the shareholder level in these cases.

The provisions of subparagraph 4(e) apply retroactively, as well as prospectively, to dividends paid on or after the first day of January of 1991. (See paragraph 3(a) of Article 33 (Entry into Force).) The French Government has developed procedures and forms for claiming available refunds.

In each case, the United States will treat the refund of all or a portion of the French company tax as a withholding of the shareholder-level tax. Thus the tax credit is included in the dividend income of the U.S. shareholder, just as a withholding tax on the dividend would be.

Where required by the French tax administration, the beneficial owner of a dividend that qualifies for a French tax credit must show that he is the beneficial owner and that the shareholding does not have as one of its principal purposes the purpose of allowing another person to take advantage of this paragraph 4 of the Convention.

Dividends paid by a French company to a resident of the United States that are not eligible for the credit provided for in subparagraph (a) or (e) of paragraph 4 are exempt from payment of the French prepayment ("précompte") otherwise payable by the French corporation with respect to those dividends. The "précompte" funds the "avoir fiscal" by collecting the company tax on the distribution of profits that did not bear the full company level tax. Thus, all qualifying shareholders receive the same amount of credit; the "précompte" corrects for differences in the underlying corporate tax. The Convention waives the "précompte" with respect to dividends distributed to U.S. shareholders not entitled to an "avoir fiscal." Refunds of the full amount of the "précompte" are available to U.S. shareholders not entitled to any dividend tax credit payment. In the case of shareholders entitled to the "avoir fiscal" payment described in subparagraph (e) of paragraph 4, a refund also will be granted, but reduced by the amount of that payment. In all cases, the gross amount of refund will be treated as a dividend for purposes

of the Convention and will be taxable in France at the rates provided for in paragraph 2.

The competent authorities may consult together and may prescribe rules, together or separately, to implement the provisions of paragraph 4. Such consultations have already taken place under the authority of the 1967 Convention.

The term "dividends" is defined in paragraph 5 to mean income from shares, "jouissance" shares or rights, mining shares, founders' shares, or other rights (not being debt claims) participating in profits, as well as income derived from other 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. The term "dividends" also includes income from arrangements, including debt obligations, that carry the right to participate in profits or that are determined with reference to profits of the issuer or of one of its associated enterprises, to the extent that such income is characterized as a dividend under the law of the source State. Distributions to directors as compensation for their services are not treated as dividends under this Article, but as directors' fees under Article 16 (Directors' Fees). As such they are taxable in France to the extent that the services are performed in France; they are not in any case eligible for the French dividend tax credit ("avoir fiscal").

The provisions of this Article also apply to beneficial owners of dividends that hold depository receipts in place of the shares themselves. The U.S.-Netherlands Convention also treats depository receipts in this way. (See Point VI of the Understanding to that Convention.) In this Convention such dividends are also eligible for the dividend tax credit to the extent authorized in paragraph 4.

Paragraph 6 excludes from the scope of this Article dividends attributable to a permanent establishment or fixed base of the beneficial owner in the source State. Such dividends will be included in the taxable income of the permanent establishment or fixed base and taxed on a net basis under the rules of Article 7 (Business Profits) or 14 (Independent Personal Services).

Paragraph 7 authorizes the imposition of a second level of tax on branch profits similar to, and at the same rate as, the tax that may be imposed under this Article on dividends paid by a subsidiary corporation in one Contracting State to its parent company in the other Contracting State. The United States tax is imposed on the "dividend equivalent amount" of profits attributable to the U.S. branch of a French company or of income or gain derived by a French company from U.S. real estate on which the company is taxed on a net basis. The term "dividend equivalent amount" is defined in section 884 of the Code. France

will impose its branch tax on the amount of after-tax branch profits deemed distributed to the home office in accordance with Article 115 "quinquies" of the French tax code. The rate of tax will be 5 percent in each case. The same tax applies to income attributable to a trade or business carried on by a partnership or other pass-through entity in which a company resident in the other Contracting State is a partner.

Paragraph 8 bars one Contracting State from imposing a tax on dividends paid by a company resident in the other Contracting State or on the undistributed profits of such a company, even if the dividends or profits consist wholly or partly of profits or income arising in that first State. Exceptions to this rule apply insofar as dividends are paid to a resident of the first Contracting State or are attributable to a permanent establishment or fixed base situated in the first State. In the former case, the country of residence may tax the dividends by virtue of paragraph 2 of Article 29 (Miscellaneous Provisions). In the latter case, the dividends are taxable by France or the United States under Article 7 (Business Profits) or 14 (Independent Personal Services).

Notwithstanding the foregoing limitations on source State taxation of dividends, the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions) permits the United States to tax dividends received by its residents and citizens, subject to the special rules of subparagraph 1(b)(ii) of Article 24 (Relief from Double Taxation), as if the Convention had not come into effect.

Article 11. INTEREST

Article 11 limits the source State taxation of interest beneficially owned by residents of the other Contracting State.

Paragraph 1 grants to each Contracting State the exclusive right to tax interest arising in the other Contracting State that is beneficially owned by residents of the first State. This preserves the exemption at source of interest provided for in the 1967 treaty, as amended by the 1984 Protocol.

The exemption at source provided in this Article also applies to the excess interest, if any, of a U.S. branch of a French company; such excess interest is treated under U.S. law as if paid to the home office.

However, paragraph 2 introduces an exception to the rule of paragraph 1 in the case of interest that is determined with reference to the profits of the issuer of the debt or to the profits of one of its associated enterprises. Interest that is contingent on profits in such a manner is subject to tax at source at a rate not exceeding 15 percent. Thus, such interest

will be taxed at the same rate as portfolio dividends, unless the domestic law of the source State provides a lower rate of tax.

Another exception preserves the U.S. right to tax an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit. This provision is in paragraph 6 of Article 29 (Miscellaneous Provisions).

The term "interest" means income from debt claims of every kind, whether or not secured by a mortgage and whether or not carrying a right to participate in profits, as well as any other income treated as income from money lent by the taxation law of the source State. Penalty charges for late payment are excluded from the definition of interest; they may be imposed notwithstanding the exemption or the limitation of tax at source on interest. Income dealt with in Article 10 is also excluded from the definition of interest. Thus, for example, if under domestic law income from a debt obligation carrying the right to participate in profits is considered a dividend, it will also be considered a dividend for purposes of the Convention, notwithstanding the fact that the Convention definition of interest includes income from debt-claims carrying the right to participate in profits. First, however, such income must be characterized as a dividend under domestic law.

Paragraph 4 excludes from the scope of this Article interest attributable to a permanent establishment or fixed base of the creditor in the source State. Such interest will be included in the taxable income of the permanent establishment or fixed base and taxed on a net basis under the rules of Article 7 (Business Profits) or 14 (Independent Personal Services).

Paragraph 5 contains the source rule for interest. This rule provides that the source of an interest payment generally is the State of residence of the payor, unless the interest is borne by a permanent establishment or fixed base in the other State, in which case the source is assigned to that other State. A source rule is provided because paragraph 1 requires that each Contracting State exempt from tax income "arising in" that State and beneficially owned by a resident of the other State. Interest arising in a third country is dealt with in Article 21 (Other Income). However, since Article 21 also provides for taxation only in the residence State, the result would be the same if this Article dealt with all interest, wherever arising, which would eliminate the need for a source rule. The latter approach has been used in some other recent U.S. treaties; the format used here follows that of the OECD Model.

An exchange of notes, signed on the same date as the Convention, confirms that paragraph 5 does not restrict the ability of either State to tax interest paid by a permanent establishment in that State to any resident of a third State. A

comparable clarification was included in an exchange of letters accompanying the 1988 Protocol.

Paragraph 6 limits the benefits of this Article to interest amounts that reflect arm's length transactions. If the interest paid exceeds an arm's length amount due to a special relationship between the creditor and the debtor, the excess amount may be taxed under the domestic law of the source State, with due regard to other provisions of the Convention. Thus, for example, if under domestic law, the excess amount is treated as a dividend, the rate provided in Article 10 (Dividends) would apply.

Notwithstanding the foregoing limitations on source state taxation of interest, the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions) permits the United States to tax the interest income of its residents, as defined in Article 4 (Resident) and its citizens, subject to the special rules of subparagraph 1(b) of Article 24 (Relief from Double Taxation), as if the Convention had not come into effect.

Article 12. ROYALTIES

Article 12 limits the source State taxation of royalties beneficially owned by residents of the other Contracting State.

Paragraph 1 preserves each Contracting State's right to tax royalties arising in the other Contracting State that are beneficially owned by residents of the first State. This is consistent with the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions).

Paragraph 2 also permits the source State to tax royalties beneficially owned by a resident of the other Contracting State, but not at a rate of more than 5 percent of the gross amount of the royalties.

Paragraph provides an exception to paragraph 2. The source State may not impose tax on copyright royalties described in subparagraph 4(a) that are beneficially owned by a resident of the other Contracting State.

Paragraph 4 defines the term "royalties." Subparagraph 4(a) 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. It includes payments for the use of, or the right to use, any neighboring right, including reproduction rights and performing rights. The definition in subparagraph 4(a) also covers payments for the use of, or the right to use, any cinematographic film, any sound or picture recording, or any software. The royalties described in this subparagraph are exempt from tax at source in accordance with paragraph 3. The references to neighboring rights and to

software simply confirm that both States share the same interpretation of the term "copyright." They are not intended to suggest that the term "copyright," as used in other U.S. treaties (including the present treaty with France), excludes software or neighboring or similar rights.

Subparagraph 4(b) includes payments for the use of, or the 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 scientific experience. Royalties described in subparagraph 4(b) are subject to tax at source at a rate of 5 percent of the gross amount, unless domestic law provides for a lower tax. Subparagraph 4(c) includes gains derived from the alienation of any right or property described in subparagraph 4(a) or (b), to the extent that such gains are contingent on the productivity, use, or further alienation of that right or property. Royalties described in subparagraph 4(c) will be either exempt at source or taxed at a rate not exceeding 5 percent depending on whether they belong under subparagraph 4(a) or 4(b).

Paragraph 5 excludes from the scope of this Article royalties attributable to a permanent establishment or fixed base of the beneficial owner in the source State. Such royalties will be included in the taxable income of the permanent establishment or fixed base and taxed on a net basis under the rules of Article 7 (Business Profits) or 14 (Independent Personal Services).

Paragraph 6 contains the source rule for royalties. Under subparagraph 6(c), royalties are treated as arising in a Contracting State when paid for the use of, or the right to use, property in that State. This place of use rule takes precedence over the rules of subparagraphs 6(a) and 6(b). When subparagraph 6(c) does not apply, because the royalty is for the use of, or the right to use, property in a third State, subparagraph 6(a) provides that the royalties arise in a Contracting State if the payer is a resident of that State within the meaning of Article 4 (Resident). However, as provided in subparagraph 6(b), where 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. This source rule applies also for purposes of Article 24 (Relief from Double Taxation).

Subparagraph 6(d) provides that royalties will be deemed paid no later than the time at which they are taken into account as expenses for tax purposes in the source State. This rule,

which also appears in the 1967 Convention, was added as an anti-abuse measure at the request of France.

Paragraph 7 limits the benefits of this Article to royalty amounts that reflect arm's length transactions. If the royalty paid exceeds an arm's length amount due to a special relationship between the payor and the beneficial owner, the excess amount may be taxed under the domestic law of the source State, with due regard to the other provisions of the Convention. Thus, for example, if under domestic law the excess amount is treated as a dividend, the rate provided in Article 10 (Dividends) would apply.

Notwithstanding the foregoing limitations on source country taxation of royalties, the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions) permits the United States to tax its residents, as defined in Article 4 (Resident), and its citizens, subject to the special rules of subparagraph 1(b) of Article 24 (Relief from Double Taxation), as if the Convention had not come into effect.

Article 13. GAINS

Article 13 limits the source State taxation of capital gains derived by residents of the other Contracting State from the alienation of property.

Paragraph 1 preserves the right of each Contracting State to tax gains from the alienation of real property situated in that State. As explained in paragraph 2, paragraph 1 permits the situs State to tax not only gains derived from the alienation of real property referred to in Article 6 (Income from Real Property) that is situated in that State, but also certain other gains that are attributable to real property situated in that State. The United States may tax the gain derived by a resident of France from the alienation of a "U.S. real property interest," as defined in Code section 897, and an interest in a partnership, trust, or estate, to the extent attributable to real property situated in the United States. France may tax the gain derived by a U.S. resident from the alienation of shares or similar rights in a company if 50 percent or more of the company's assets consist of real property situated in France or derive 50 percent or more of their value, directly or indirectly, from such real property. In addition, France may tax such gain from an interest in a partnership, a "société de personnes," an economic group, or a European economic group (provided in each case that it is not taxed as a company under French law), an estate, or a trust, to the extent attributable to real property situated in France.

Because the definition of "real property situated in a Contracting State" contained in paragraph 2 of Article 13 is specifically limited to Article 13, such definition has no effect

on the right to tax income covered in other articles. For example, the inclusion of interests in certain corporations in the definition of real property situated in the other Contracting State for purposes of permitting source country taxation of gains derived from dispositions of such interests under Article 13 does not affect the treatment of dividends paid by such corporations. Such dividends remain subject to the limitations on source country taxation contained in Article 10 (Dividends) and are not governed by the unlimited source country taxation right contained in Article 6 with respect to real property.

In the case of gains from the alienation of movable property, paragraph 3 of Article 13 preserves the source country right to tax in certain circumstances. Subparagraph 3(a) provides that gains from the alienation of movable property forming part of the business property of a permanent establishment or fixed base that an enterprise of a Contracting State has in the other Contracting State, 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. If the removal of such property from a Contracting State is treated by that State as a deemed alienation of the property, that State may tax the gain as of the date of removal (but not any subsequent gain) and the other State may not tax that gain (but only any subsequent gain). For U.S. tax purposes, the taxpayer will carry over the basis of the property and will be required to substantiate its fair market value on the date of removal from France in computing any subsequent gain that becomes taxable in the United States. This provision does not affect the operation of Code section 987 with respect to foreign currency gain or loss on remittances by a qualified business unit of property or currency.

An exchange of notes, signed on the same date as the Convention, acknowledges that the meaning of "business property," as used in subparagraph 3(a), is narrower in some cases than the term "assets," used in paragraph 2, despite the use in French of the same term in both places.

Subparagraph 3(b) permits the taxation of gain attributable to a permanent establishment or fixed base under subparagraph 3(a), even if the permanent establishment or fixed base no longer exists when the payments are made. This parallels the rule of paragraph 7 of Article 7 (Business Profits) and paragraph 2 of Article 14 (Independent Personal Services).

Paragraph 4 provides that gains derived by an enterprise that operates ships or aircraft in international traffic from the alienation of such ships or aircraft or of movable property pertaining to their operation shall be taxable only in the Contracting State of which the enterprise is a resident.

Paragraph 5 provides that gains described in subparagraph 4(c) of Article 12 (Royalties) may be taxed only in accordance with that Article. Thus, the source country will either exempt such gains or tax them at not more than 5 percent, in accordance with Article 12 (Royalties).

Paragraph 6 states that, except as provided in paragraph 5, gain from the alienation of any property not referred to in the preceding paragraphs of this Article may be taxed only in the Contracting State of which the person deriving the gain is a resident. Thus, gain from the sale of corporate securities or other tangible personal property not covered by paragraph 3 is exempt from tax at source.

Notwithstanding the foregoing limitations on source State taxation of certain gains, the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions) permits the United States to tax the capital gains of its residents, as defined in Article 4 (Resident), and citizens, subject to the special rules of subparagraph 1(b) of Article 24 (Relief from Double Taxation), as if the Convention had not come into effect.

Article 14. INDEPENDENT PERSONAL SERVICES

The Convention covers different classes of income from personal services in separate articles. Article 14 deals with the general class of income from independent personal services, and Article 15 deals with the general class of dependent personal service income. Exceptions or additions to these general rules are provided for directors' fees (Article 16), performance income of artistes and sportsmen (Article 17), pensions in respect of personal service income (Article 18), salaries and pensions related to government employment and social security benefits (Article 19), the income of visiting teachers and researchers (Article 20), and certain income of students and trainees (Article 21).

Paragraph 1 of Article 14 provides the general rule that a resident of a Contracting State who derives income from the performance of professional services or other activities of an independent character will be exempt from tax by the other Contracting State in respect of that income unless certain conditions are satisfied. The income may be taxed in the other Contracting State only if the services are performed there and the income is attributable to a fixed base regularly available to the resident in that other State for the purpose of performing his services. This Article deals with income from performing services; Article 7 deals with income from furnishing the services of others.

As in the case of Articles 7 (Business Profits) and 13 (Capital Gains), paragraph 2 provides that the income

attributable to a fixed base in a Contracting State with respect to services performed there may be taxed by that State even if receipt of the income is deferred until the fixed base no longer exists. If the income was attributable to a fixed base in that State, the tax cannot be avoided by deferring the payment.

If the individual is a U.S. citizen, the United States may, by virtue of the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions), tax his income without regard to the restrictions of this Article, subject to the special rules of subparagraph 1(b) 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," as defined in Article 5 (Permanent Establishment). Therefore, 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. Under both Articles, the income of a resident of one Contracting State must be attributable to a permanent establishment or fixed base in the other State in order for that other State to have a taxing right. Under Article 14, the income also must be attributable to services performed in that other State. Article 7 does not require that all of the activities generating the income be performed in the State where the permanent establishment is located.

Paragraph 3 of Article 13 notes that the term "professional services" includes independent scientific, literary, artistic, educational, and teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list is not meant to be 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.

Paragraph 4 contains a special rule that is carried over from the 1967 Convention, as amended by the Protocols of 1978 and 1984. It provides that the earned income derived by a partner in a partnership generally will have the same character and source that it has at the partnership level. Thus, for example, a resident of France (whether or not a U.S. citizen) who is a partner in a U.S. partnership will be considered, for purposes of French income tax, to have received U.S. source income to the extent that his or her distributive share in the partnership profit or loss consists of U.S. source income. However, the paragraph also provides that, for purposes of Article 24 (Relief from Double Taxation), this provision shall not result in France

exempting from tax (or giving a credit equal to the French tax on) more than 50 percent of the earned income of the partnership that accrues to the resident of France. This exception to the general principle of the paragraph was provided to preserve the revenues of France in the event that the French office shows a loss or a relatively low profit compared to the resident partner's distributive share of the total partnership income.

For example, if a partnership of two equal partners, one of whom is a resident of France, has $100,000 of earned income of which $20,000 is derived from the French office, each partner's share (absent any special allocation) would amount to $50,000, of which only $10,000 would be of French source. Under this rule, France is permitted to tax the resident partner on $25,000 (50 percent of $50,000). However, the additional income taxable by France ($15,000) as a result of this special rule will reduce the amount of earned income from French sources otherwise taxable by France to partners who are not residents of France. Thus, in this example, France would not be permitted to tax the $10,000 of French source income attributable to the nonresident partner. Further, the additional income taxable by France ($15,000) will be deemed to be from French sources only if the partnership elects to treat it as such and agrees to treat as U.S. source income an equivalent amount of foreign (non-U.S.) income of the partners who are not residents of France. That provision is discussed under Article 24.

Article 15. DEPENDENT PERSONAL SERVICES

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

Paragraph 1 provides that remuneration derived by an employee who is a resident of a Contracting State generally may be taxed by the other Contracting State only to the extent that the remuneration is derived from an employment exercised in the other Contracting State.

Under paragraph 2, even where the remuneration of a resident of a Contracting State is derived from employment exercised in the other Contracting State, that other State may not tax the remuneration if three conditions are satisfied: (1) the individual is present in the other Contracting State for a period or periods not exceeding 183 days in any 12-month period that begins or ends in the taxable year concerned; (2) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other 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 other State.

For the remuneration to be exempt from tax in the source State, all three conditions must be satisfied. If the first condition is met, the individual generally will become a resident of the State where the services are performed for purposes of its taxation. He may also continue to be a resident of the other State under its law, in which case the tie-breaker rules of Article 4 (Resident) will be applied to determine a single country of residence. Even if Article 4 determines that he is not a resident for treaty purposes of the State where the services are performed, the length of time spent there is sufficient, under paragraph 2, to entitle that country to tax the income from those services. Conditions (2) and (3) are intended to assure that a Contracting State will not be required to allow a deduction to the payor for the amount paid and also to exempt the employee on the amount received. 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, neither condition (2) nor (3), as the case may be, will be considered to have been fulfilled.

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. The "regular complement" includes the crew. It may also include others employed by the shipping company to perform services 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 or a person, such as an entertainer, who boards the ship only during a visit to a particular port, is not covered by this paragraph.

A U.S. citizen resident in France who performs dependent services in the United States and meets the conditions of paragraph 2, or is a crew member on a ship or airline operated in international traffic, is, nevertheless, taxable in the United States on his remuneration by virtue of the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions), subject to the special rule of subparagraph 1(b) 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 in that State by a resident of the other Contracting State in his capacity as a director of the company. This rule is an exception to the more general rules of Articles 14 (Independent Personal Services) and Article 15 (Dependent

Personal Services). The State of residence of the corporation may tax nonresident directors without regard to the conditions of Articles 14 and 15, but only with respect to remuneration for services performed in that State and subject to the provisions of Article 25 (Non-Discrimination).

No such provision was included in the 1967 Convention. It is the preferred U.S. policy not to provide a special rule for directors' fees, but 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 14 (Independent Personal Services) and inside directors would be subject to the provisions of Article 15 (Dependent Personal Services). The preferred French 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 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.

Under French tax law, directors' fees are taxed like dividends, at a rate of 25 percent. For this purpose, directors' fees do not include reimbursed expenses. Under the Convention, directors' fees are explicitly excluded from the definition of dividends to clarify that they do not give rise to the dividend tax credit ("avoir fiscal").

This Article is subject to the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions). Thus, if a U.S. citizen who is a French 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 to the special rules of paragraph 1(b) of Article 24 (Relief from Double Taxation).

ARTICLE 17. ARTISTES AND SPORTSMEN

This Article deals with the taxation in a Contracting State of income earned by artistes (<u>i.e.</u>, performing artists and other entertainers) and sportsmen who are residents of the other Contracting State for their services as entertainers or sportsmen. The term "sportsmen" was substituted for the term "athletes" in the 1992 revision of the OECD Model to clarify that the term includes participants in golf and tennis tournaments, jockeys, racing drivers, participants in chess and bridge tournaments, and others who might not be considered "athletes" in the traditional sense. The Article applies to the income of an entertainer or sportsman for services performed either on his own behalf or on behalf of another person, whether as an employee of that other person or pursuant to another arrangement. This Article applies, however, only with respect to the income of the

performers themselves and, in cases covered by paragraph 2, to income received by certain persons providing the services of the performers. Others involved in an entertainment or athletic event, such as technicians, managers, and coaches, remain subject to the provisions of Articles 14 and 15.

Paragraph 1 provides that income derived by a resident of a Contracting State from personal activities exercised in the other Contracting State as an entertainer or sportsman may be taxed in that other State if the amount of the gross receipts derived by the individual exceeds $10,000 (or its equivalent in French francs) for the calendar 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 only the excess, may be taxed in the State of performance. The $10,000 threshold is the same as in the 1967 Convention.

The OECD Model provides for taxation by the State of performance of the remuneration of entertainers or sportsmen with no dollar or time threshold. The United States recognizes that entertainers and sportsmen will typically not meet the fixed base or 183-day tests of Articles 14 and 15, but takes the position that those who earn only modest amounts for their services, as is generally true of members of an orchestra or dance company, for example, are not clearly distinguishable from those who earn other types of personal service income and should be treated under Article 14 or 15, as appropriate. Thus, it prefers to limit this Article to those whose earnings exceed a specified dollar threshold.

Paragraph 1 applies notwithstanding the provisions of Articles 14 (Independent Personal Services) or 15 (Dependent Personal Services). If an individual would otherwise be exempt from tax under those Articles, but is subject to tax under this Article he may be taxed under this Article. However, an entertainer or sportsman who receives less than the $10,000 threshold amount may, nevertheless, be subject to tax in the host State under Article 14 or 15, provided that the tests for taxability under those Articles are met.

It may not be possible to know until year-end whether the income an entertainer or sportsman derived from performing such services in a Contracting State will exceed the threshold amount. However, nothing in the Convention precludes a Contracting State from withholding tax at the time of payment and refunding the excess, if any.

Income derived from a Contracting State by an entertainer or sportsman who is a resident of the other Contracting State in connection with his activities as such, but from other than an actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this

Article. Such income is, however, subject to the provisions of other articles of the Convention, if applicable, such as Article 12 (Royalties) or Article 14 (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 12, even if the remuneration from the concert itself may have been covered by this Article.

Paragraph 2 is intended to deal with the potential for abuse when income from a performance by an entertainer or sportsman 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 intended or realized. on the other hand, the "employer" may be a company established and owned by the performer that is merely acting as the nominal income recipient in respect of the remuneration for the entertainer's performance. In such case, absent the provisions of paragraph 2, the company providing the entertainer's services could escape host State tax because it earns business profits but has no permanent establishment in that State. The income could later be paid out to the entertainer when he no longer has any presence in the State where the income originated.

Paragraph 2 seeks to prevent this type of abuse while at the same time allowing 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 State, its income may be subject to tax there under the provisions of paragraph 2. If the putative "employer" is not a resident of either Contracting State, each Contracting State may impose tax according to its domestic law.

Taxation under paragraph 2 is on the person providing the services of the entertainer or sportsman. This paragraph does not affect the rules of paragraph 1, which apply to the remuneration of the entertainer or sportsman. However, wage or salary payments to the performer would reduce the income taxable to the person providing his services.

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

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

Paragraph 2 does not apply if it is established that neither the entertainer or sportsman, nor any persons related to the entertainer or sportsman, participate directly or indirectly in the profits of the person providing the services of the entertainer or sportsman. This exception for non-abusive cases is not in the OECD Model, but reflects the U.S. position that the purpose of the paragraph is to prevent abuse of the provisions of Articles 7 (Business Profits) and 14 (Independent Personal Services) in this context.

Paragraph 3 of the Article 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 sportsman who is a resident of the other Contracting State, if the visit is principally supported, directly or indirectly, by the public funds of his State of residence or of a political subdivision (in the case of the United States) or local authority of that State. In that case, only the Contracting State of which the entertainer or sportsman is a resident may tax his income from those services. Some other recent U.S. treaties, including the treaty with Germany, provide a similar exception.

This Article is subject to the provisions of the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions). Thus, if an entertainer or sportsman who is a resident of France 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 provisions of paragraph 1(b) of Article 24 (Relief from Double Taxation).

ARTICLE 18. PENSIONS

This Article deals with the taxation of private pensions and social security benefits.

Under subparagraph 1(a), private pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment are taxable only in the State of residence of the recipient. This rule applies to both periodic and lump-sum payments. The rule applies to pension payments in consideration of past employment that are paid to a resident of the other Contracting State, whether to the employee or to his or her beneficiary.

Government pensions paid in respect of past government employment are covered under Article 19 (Public Remuneration). However, government payments under the social security legislation of a Contracting State generally are dealt with in subparagraph 1(b) of this Article. This subparagraph provides that benefits may be taxed only by the paying State. It also provides that payments under the social security legislation of France to a resident of France who is a U.S. citizen may be taxed only by France. This additional sentence is necessary because the subparagraph otherwise addresses only payments by one State to residents of the other State.

Paragraph 2 is based on paragraph 5(a) of Article 19 of the 1967 Convention, as amended in 1984, and on the suggested provision set forth in the Commentaries to Article 19 of the 1992 OECD Model. It permits an individual resident of a Contracting State who is not a national of that State to deduct contributions in respect of personal services rendered that are made by or on his behalf to certain pension or other retirement arrangements in the other State, to the same extent that deductions would be permitted in the first State for contributions to such arrangements. The retirement arrangement must be recognized for tax purposes in the other State, and the competent authority of the State permitting the deduction must agree that the arrangement in the other State generally corresponds to an arrangement that is established and maintained and recognized for tax purposes in the first State.

France has both mandatory and non-mandatory pension plans. The relevant comparison, for purposes of determining the amount and timing of deductions for French tax purposes of amounts contributed to a U.S. retirement arrangement, is to the French mandatory plans, provided that the French competent authority agrees that the U.S. arrangement in question generally corresponds to the French mandatory plan (even though the U.S. arrangement may not be mandatory). In either Contracting State, a retirement arrangement will qualify as "recognized for tax purposes" in that State if contributions to it qualify for tax relief in that State. (This provision is narrower in this respect than is paragraph 4(e)(ii)(cc) of Article 10 (Dividends).)

Paragraph 3 provides that the residence State will follow the rules of the other State as to when retirement benefits from an arrangement that qualifies for the benefits of paragraph 2 are taken into income for purposes of computing the tax liability of the beneficiary. This provision carried over from paragraph 5(b) of Article 19 of the 1967 Convention, as amended in 1984. It was originally introduced in the side letter to the 1978 Protocol for the purpose of providing French benefits to U.S. citizens resident in France. It was included in the text of the Convention, reciprocally, in 1984.

Article 19. PUBLIC REMUNERATION

Paragraph 1 deals with the taxation of government compensation. Under subparagraph i(a), wages, salaries, and similar compensation (other than pensions) paid by the United States, its states or local authorities, or by any government agency or instrumentality to any individual generally are exempt from French tax. However, under subparagraph 1(b), such payments are taxable in France, and only in France if the payee is a resident and national of France and not also a U.S. citizen, and the remuneration is for services performed in France. Thus, for example, if the U.S. Embassy in Paris hires a local resident who is a French national and not a U.S. citizen, the salary paid to that individual will be taxable only by France. However, if the individual is a U.S. citizen or a national of a third country, the wage or salary will be taxable only by the United States. In the converse case, the rule differs because of the unilateral effect of the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions). If the French Embassy in Washington hires a U.S. resident, there will be a U.S. income tax on the remuneration for those services if the individual is a U.S. citizen or holds a green card. In either of such cases, the U.S. may tax the wage or salary received from the French Government under the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions). If that individual is a dual national of the United States and France, subparagraph 1(c) of Article 24 (Relief from Double Taxation) provides that the income for services rendered to the French Government will be treated as French source income for purposes of the U.S. foreign tax credit. Thus, the United States may tax the income but must allow a credit for the French income tax, if any, in accordance with the provisions of Article 24.

Paragraph 2 deals with the taxation of pensions paid in respect of the services described in paragraph 1. The general rule is that the State that pays the pension has the exclusive right to tax it. However, an exception permits the other State to tax when the beneficiary of the pension is a resident and national of that State and not also a national of the first State. The rules of paragraph 2 do not apply to social security benefits and other public pensions that are not in respect of services rendered to the paying government or a political subdivision or local authority thereof; such amounts are taxed exclusively by the source State under the terms of paragraph 1(b) of Article 18 (Pensions). However, paragraph 2 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. Thus, in the unusual case where a French resident national (who is not also a U.S. citizen) derives a pension for U.S. Government employment that is paid under the social security system, only France may tax that pension, as provided by paragraph 2(b). This could happen, for example, if

the locally hired driver for the U.S. Embassy in Paris referred to earlier were to retire and receive a U.S. pension under social security. Again, in the converse case, the saving clause of paragraph 2 of Article 29 (Miscellaneous Rules) permits the United States to tax a pension paid by France to a U.S. citizen or resident alien; but if the individual is also a French national the United States will treat such a pension as French source income under subparagraph 1 (c) of Article 24 (Relief from Double Taxation) and allow a foreign tax credit for the French tax paid with respect to that income.

As provided in paragraph 3, the rules of paragraphs 1 and 2 are not applicable when the remuneration is for services performed in connection with a business carried on by a governmental body. In such cases, the rules that apply are the same as those applicable to private sector remuneration and pensions.

Article 20. TEACHERS AND RESEARCHERS

This Article provides a special two-year exemption of the compensation of certain teachers and/or researchers who are residents of one Contracting State and visit the other State to teach or to carry out research. There is no provision in the OECD Model dealing with professors or teachers. It is not standard U.S. treaty policy to provide benefits to visiting teachers by treaty. When, however, the treaty partner wishes to include such a provision, the United States may agree to do so, particularly, as in this case, when an existing Convention with that partner contains a similar provision (see Article 17 of the 1967 Convention).

To qualify, the individual must be a resident of France or the United States immediately before visiting the other Contracting State, and must be invited by the Government or by a university or other recognized educational or research institution in the other State for the primary purpose of teaching or conducting research. In that case, the remuneration for those teaching or research services is exempt in that other State from its income taxes listed in Article 2 (Taxes Covered) for a period of not more than two years from the individuals date of arrival there. A "recognized research institution" would include such research facilities as the National Institutes of Health and the Centers for Disease Control.

The Convention adds the limitation that the benefit of this provision may not be claimed more than once by the same individual.

Paragraph 2 denies the benefit of this exemption in the case of research if the research is undertaken for private benefit rather than in the public interest. For example, the exemption

would not apply to a grant from a tax-exempt research organization to search for a 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. (See subparagraph 3(b) of Article 29 (Miscellaneous Provisions). Thus, the benefits are available to individuals who are not U.S. citizens and do not have immigrant status (a "green card")), even if they would otherwise become U.S. residents under Code section 7701 (b) and Article 4 (Resident).

Article 21. STUDENTS AND TRAINEES

Paragraph 1 of this Article provides a limited exemption of certain payments derived by an individual who visits one of the Contracting States as a student, to acquire professional training, or as the recipient of a research or study grant from a not-for profit governmental, religious, artistic, cultural, or educational organization, if the individual was a resident of the other Contracting State immediately before such visit.

The individual must visit the other State for the primary purpose of studying, doing research, or acquiring training. Holding a part-time job in addition will not disqualify the individual, but the benefits of this Article are intended for full-time students, researchers, and trainees. Nor is the exemption available to an individual who visits the other State for the primary purpose of performing research, for example as a research assistant, for another individual who received a research grant from a qualifying tax-exempt organization. The exemption for researchers provided in this Article is restricted to individuals who are themselves grant recipients.

The amounts that may qualify for exemption under this Article are gifts from abroad to cover living expenses and the costs of the study, research, or training; the grant from the not-for-profit organization; and up to 5,000 dollars per year, or the equivalent in French francs, of compensation for personal services. The exemption provided for a grant does not include any element of compensation for services. The exemption of the first 5,000 dollars of compensation is in addition to any personal exemption or deductions permitted under domestic law.

The exemptions continue for the period of time reasonably or customarily required to complete the program of study, research, or training. The same individual may claim the benefits of this Article and of Article 20 (Teachers and Researchers), but the combined period of benefits may not exceed five years.

Paragraph 2 provides benefits to an individual who is either an employee of, or under contract with, an enterprise of a Contracting State and who is temporarily present in the other Contracting State for the primary purpose of: (1) acquiring technical, professional, or business experience from a person other than his employer, or (2) studying at a university or other recognized educational institution in that other State. Such an individual will be exempt from tax by that other State on up to 8,000 dollars, or the equivalent in French francs, of compensation for his personal services. If the compensation exceeds $8,000, the excess is taxable under the domestic law of the host State. The exemption of the first $8,000 of compensation is in addition to any personal exemption and deductions permitted under domestic law.

This exemption is available only for a period of 12 consecutive months. If the period of training exceeds 12 months, any compensation derived after that time period is taxable in accordance with the domestic law of the host State. The purpose of the exemption is to permit companies that are residents of a Contracting State to send employees to the other Contracting State for training, while continuing to pay them a modest salary, without subjecting the individual to a tax liability in the other State on those payments. In the absence of such a provision, the payments would be considered compensation for services rendered in the other State and would be fully taxable there.

Because of the exception to the saving clause in subparagraph 3(b) of Article 29 (Miscellaneous Provisions), the saving clause does not apply with respect to a person entitled to U.S. benefits under the provisions of this Article if that person is not a U.S. citizen and does not have immigrant status in the United States. Thus, for example, a French resident who visits the United States as a student or professor and becomes a U.S. resident by virtue of staying more than 183 days would be exempt from U.S. tax in accordance with this Article, even if he ceased to be a resident of France under its rules, as long as he is not a U.S. citizen and does not have immigrant status in the United States (a "green card"). The saving clause does apply to U.S. citizens and resident aliens who have immigrant status in the United States.

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. 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 applies to classes of income that are not dealt with elsewhere, such as, for example, alimony, annuities, child support payments and lottery winnings. In addition, it applies to income from

sources in third States that is of the same class as income dealt with in another article of the Convention, where that other article deals only with such income from sources within a Contracting State.

Paragraph 1 contains the general rule that such items of income will be taxable only in the State of residence of the beneficial owner. This exclusive right of taxation applies whether or not 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 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 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 France would be taxable by the United States.

The exception to the general rule of paragraph 2 for income from real property provides that, 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 income from the property if neither the situs of the property nor the residence of the owner is in that State. For example, if a French 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 France 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 (Income from Real Property) and 23 (Capital), that only the situs and residence States may tax real property and real property income.

This Article is subject to the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions). Thus, the United States may tax the income of a French resident not dealt with elsewhere in the Convention, if that individual 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 taxes on capital, the only capital tax now covered by the Convention is the wealth tax imposed by France.

Paragraph 5 of this Article provides the general rule that capital owned by a resident of a Contracting State may be taxed only by that Contracting State. Paragraphs 1 through 4 are exceptions to this general rule.

Paragraph 1 provides that capital represented by real property (as defined in Article 6 (Income from Real Property)) that is located in a Contracting State may be taxed by that Contracting State, including such property owned by a resident of the other State. The same rule applies to shares or other interests in a company whose assets consist at least 50 percent of such property, or derive at least 50 percent of their value, directly or indirectly, from such property, and to an interest in a person other than an individual or company to the extent that the assets of that person consist of real property or derive their value, directly or indirectly, from real property.

Paragraph 2 permits a Contracting State to tax an individual on capital represented by shares or other rights (other than those covered by paragraph 1) in a company that is a resident of that State if the individual owns a substantial interest in the company. For this purpose a substantial interest is one that gives the right to 25 percent or more of the corporate earnings; it includes the interests of the individual and any related persons.

Under paragraph 3, capital represented by movable property that is part of the business property of a permanent establishment or fixed base maintained in one Contracting State by a resident of the other may be taxed by the State where the permanent establishment or fixed base is located. As explained in the exchange of notes, the meaning of "business property" may be narrower than the meaning of "assets" used in paragraph 1, notwithstanding the use of the single French term "actif" to translate both concepts.

Ships and aircraft operated in international traffic by an enterprise of a Contracting State, and movable property related to such operations, such as containers and trailers, are taxable only by the State in which the operating enterprise is resident.

All other elements of capital owned by a resident of a Contracting State are exempt from tax by the other Contracting State. This includes capital represented by corporate shares owned by individuals that do not constitute a "substantial interest," as defined in paragraph 2, and shares owned by a corporation in a subsidiary or other corporation.

Paragraph 6 provides a special rule limiting the application of the French wealth tax to U.S. citizens (other than French nationals) who become residents of France. This provision was introduced in the 1984 Protocol to the 1967 convention. It

allows such individuals to exclude assets situated outside of France from the base of assessment of the wealth tax for each of the first five years after the individual becomes a resident of France. This benefit may be claimed more than once, but only if the individual ceases to be a resident of France for at least three years before again becoming a resident of France.

Article 24. RELIEF FROM DOUBLE TAXATION

This Article describes the manner in which each Contracting State undertakes to relieve double taxation. The United States uses the foreign tax credit method exclusively. France uses a combination of foreign tax credit and exemption methods. The provisions of this Article are more complicated than in most U.S. income tax treaties, because they include special relief provisions for U.S. citizens resident in France. The format of the Article has been revised, but the provisions are substantially the same as in the 1967 Convention (as amended by subsequent Protocols).

In subparagraph 1(a), the United States agrees to allow its citizens and residents to credit against their U.S. income tax the income taxes paid or accrued to France. Subparagraph 1(a) also 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 French corporation in which the U.S. corporation owns at least 10 percent of the voting power. The deemed-paid credit is for the tax paid by the French corporation on the portion of the profits that is distributed as dividends to the U.S. parent company.

The credits provided under the Convention are 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 of the U.S. statutory credit at the time a credit is given. The limitations of U.S. law 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 an overall or per-country basis or on some variation thereof.

Subparagraph 1(b) provides special rules to avoid the double taxation of U.S. citizens who are residents of France. Under subparagraph 2(a)(iii), France agrees to credit the U.S. tax paid, but only for the amount of tax that the United States could impose under the Convention on a resident of France who is not a citizen of the United States. Under subparagraph 1(b), the

United States agrees that, where additional U.S. tax is due solely by reason of citizenship, it will credit the French tax imposed on the basis of residence to the extent that the French tax exceeds the tax that the United States may impose on the basis of source (i.e., net of the credit allowed by France). Under subparagraph 2(b), France shares the burden of avoiding double taxation of U.S. citizens resident in France by exempting from French tax certain items of U.S. source income of such citizens that would otherwise be subject to French tax.

Subparagraph 1(b) also provides that certain U.S. source income will be treated as French source income to permit the additional credit to fit within the foreign tax credit limitation of Code section 904. This re-sourcing provision applies only to items of income that are included in gross income for French tax purposes, and it cannot be used in determining the foreign tax credit limitation applicable to income taxes paid to any other country.

The following simplified example illustrates how subparagraph 1(b) works. The U.S. tax on a dividend paid by a U.S. corporation to a portfolio investor resident in France is limited by Article 10 (Dividends) of the Convention to 15 percent. The United States, therefore, will impose a tax of 15 on a dividend of 100, and France will allow a tax credit of 15. Suppose that the French individual income tax due is 22 percent. In that case, the net tax payable to France will be 7. However, assume that this individual is a U.S. citizen and, therefore, liable to U.S. tax of 28 percent. In the absence of a special relief provision, the individuals total tax would be 35: 28 to the United States, with no foreign tax credit because the dividend is from U.S. sources, and 7 to France. Under subparagraph 1(b), the 7 of French tax is credited against the 28 of U.S. tax, reducing the combined burden to 28, the higher of the two taxes. In this example, in order to credit the French tax of 7 at a U.S. rate of 28, 25 of the dividend would be treated as from French sources so that the 7 of French tax could be claimed as a foreign tax credit (7/28 x 100). Additional examples of the calculation of this additional credit are provided in IRS Publication 901 on U.S. tax treaties.

Subparagraph 1(c) contains another special rule, designed to avoid double taxation of French Government employees performing government services in the United States where those employees are dual nationals, i.e., U.S. citizens as well as nationals of France. Under of the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions), such individuals are subject to U.S. tax as U.S. citizens. However, subparagraph 1(c) provides that the remuneration paid by the French Government will be treated as French source income, so that the French tax on that remuneration will be allowed as a foreign tax credit up to the amount of the U.S. tax liability. A similar provision appears in paragraph 3

of Article 16 (Governmental Functions) of the 1967 Convention. That provision is drafted reciprocally, but it has no effect in the reverse case, since France does not tax on the basis of citizenship.

Subparagraph 1(d) preserves from the 1967 Convention, as amended in 1984, a re-sourcing rule that permits a partnership with an individual French resident partner to elect to treat as French source income any earned income that is taxable by France solely by reason of the 50-percent threshold provided in paragraph 4 of Article 14. If such an election is made, however, any additional French source income it creates will reduce other non-U.S. source earned income of the partnership that would otherwise be allocated to partners who are not residents of France, starting with other French source earned income and then reducing earned income from third countries. The foreign source income so reduced is treated as U.S. source income for foreign tax credit purposes. If there is not enough other foreign source earned income to fully offset the amount of U.S. source earned income re-sourced as French income, the excess is carried forward and reduces other foreign source earned income in future years. If one or more of the partners resident in France is a U.S. citizen, this provision may not be used to reduce the U.S. tax below what the U.S. taxpayer's liability would be before taking into account the foreign earned income exclusion of section 911. The election must be made by the partnership and is binding on all partners.

Subparagraph 1(e) provides that, for the purposes of this Article, the French income tax and company tax described in subparagraphs (b)(i) and (ii) of paragraph 1 of Article 2 are considered income taxes and thus eligible for the U.S. foreign tax credit, as are any identical or substantially similar taxes imposed after the date of signature of the Convention.

Paragraph 2 establishes the methods by which France relieves double taxation of its residents who have U.S. source income. French law generally provides for an exemption from tax of business profits earned abroad by a French company and an exemption of 95 percent of the dividends received by a French company from its foreign subsidiaries. Those exemptions are preserved in the Convention. In other cases, France avoids double taxation in the Convention by granting a foreign tax credit. However, in some cases the amount of credit is equivalent to the French tax otherwise due and, therefore, amounts to exemption of that income from French tax. In other cases, the credit is limited to the U.S. tax imposed on the income, up to the amount authorized in the relevant article of the Convention (without regard to the saving clause). The credit is also limited to the French tax attributable to such income.

In general, under the Convention, France exempts from tax (i.e., gives a credit equal to the French tax on) U.S. source dividends, interest, royalties, capital gains on real property, directors' fees, compensation of entertainers and sportsmen, and income from independent personal services. In the case of independent personal services income, the effective exemption is subject to the 50-percent limit provided in paragraph 4 of Article 14 with respect to partnership earned income. These rules are provided in subparagraphs (a)(ii) and (iii) of paragraph 2. Where the French tax is imposed at graduated rates, the exempt income is taken into account in determining the rate applicable to the non-exempt portion. (See subparagraph 2(d)(ii)(bb).) Other income is generally subject to French tax with a credit for the U.S. tax paid, up to the amount of tax that the United States may impose under the relevant article of the Convention (without regard to the saving clause that permits taxation of U.S. citizens and residents under U.S. domestic law rules), and limited to the French tax attributable to such income. This rule is provided in subparagraph 2(a)(i).

However, as noted above, France shares the responsibility of avoiding double taxation of U.S. citizens who are residents of France. It does so by exempting certain additional items of U.S. source income of such individuals. Those additional items, listed in subparagraph 2(b), include certain U.S. source dividends, interest, and royalties; capital gains from the alienation of the assets generating such dividends, interest, and royalties; profit or gain from trading in options or futures on a public U.S. options or futures market; private pensions attributable to periods of employment during which services were rendered principally in the United States;, income of teachers, researchers, students, and trainees that would be exempt from U.S. tax under the Convention if derived by a U.S. resident who was not a U.S. citizen, and U.S. source alimony and annuities. To benefit from these additional exemptions, the individual must provide certification upon request by the French competent authority, demonstrating that he has complied with his U.S. income tax obligations. This provision corresponds to the provision introduced into the 1967 Convention by the 1978 Protocol, as subsequently modified by the 1984 and 1988 Protocols.

Subparagraph 2(c) provides that France will allow a foreign tax credit against its tax on capital for any capital tax that the United States may impose in the future, up to the amount of the French capital tax. This provision applies in addition to paragraph 6 of Article 23 (Capital), which excludes certain non-French assets from the wealth tax in the case of U.S. citizens.

Subparagraph 2(e) clarifies that the Convention does not prevent France from applying three provisions of its domestic law with respect to French residents. These clarifications are added

to prevent any uncertainty that might arise from the absence of a saving clause with respect to French taxation of its residents. The first subparagraph establishes that France may continue to allow domestic companies to elect to be taxed on a worldwide basis, with a foreign tax credit, instead of applying its general territorial system of exempting foreign business income. The second subparagraph refers to the provision of French domestic law that permits business losses of foreign branch or subsidiary operations to be taken into account, but requires the inclusion of profits of such operations to recover those losses. The third refers to cases in which France requires a French parent company to be taxed currently on the earnings of a foreign subsidiary, whether or not such earnings are distributed. The purpose of the latter provisions is analogous to the purpose of the U.S. subpart F legislation, but France uses a different approach to identify low-taxed passive income.

Article 25. NONDISCRIMINATION

This Article assures that nationals and residents of a Contracting State will not be subject to discriminatory taxation in the other Contracting State. It also provides for nondiscriminatory taxation of residents of the taxing State with respect to deductions for amounts paid to residents of the other State. Finally, this Article prohibits a Contracting State from imposing discriminatory taxation upon its resident companies that are owned, partly or wholly, by residents of the other State.

Paragraph 1 provides that a national of one Contracting State who is a resident of the other Contracting State may not be subject to taxation or connected requirements in the other State that are different from, or more burdensome than, the taxes and connected requirements imposed upon a national and resident of that other State in the same circumstances. The term "national" here refers to individual citizens. The fact that this paragraph, unlike the OECD Model, applies only to residents of one of the Contracting States is not intended to suggest a different result. Neither Contracting State imposes discriminatory taxation on individuals resident in third States based on their nationality. Since the paragraph is limited to residents of the Contracting States it was not necessary to add the usual clarification that U.S. citizens resident in third countries are not "in the same circumstances" with respect to U.S. tax as French nationals resident in third countries.

Paragraph 2 of the Article provides that a permanent establishment in a Contracting State of an enterprise of the other Contracting State may not be less favorably taxed in the first State than an enterprise of that first State carrying on the same activities. This provision does not prevent either Contracting State from imposing the branch profits tax described in paragraph 5 of Article 10 (Dividends). Nor does it obligate a

Contracting State to grant to a resident of the other Contracting State any tax allowances, reliefs, or similar benefits that it grants to its own residents on account of their civil status or family responsibilities. Thus, if an individual resident in France owns a French enterprise that has a permanent establishment in the United States, in determining income tax on the profits attributable to the permanent establishment, the United States is not obligated to allow to the French resident the personal allowances for himself and his family which would be allowed 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 that has 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 French 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, but, like other withholding on payments to nonresident aliens or foreign entities, 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. The tax withheld under section 1446 is a tentative tax. If it exceeds the final liability, the partner may file a U.S. tax return claiming a refund of the excess.

Paragraph 3 prohibits discrimination in the allowance of deductions. When an enterprise of a Contracting State pays interest, royalties, or other disbursements to a resident of the other Contracting State, the first 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 Contracting 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 7 of Article 12 (Royalties) apply, because all of 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 amount 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 3 also provides that any debts of an enterprise of a Contracting State to a resident of the other Contracting State

are deductible in the first Contracting State in computing the capital tax of the enterprise, under the same conditions as if the debt had been contracted to a resident of the first-mentioned Contracting State. Although the United States does not now impose a national tax on capital, this Article applies to taxes imposed at all levels of government. This provision may, therefore, be relevant to state and local taxes on capital, such as real property taxes, imposed on enterprises.

In addition, paragraph 3 provides that the French rules to prevent "earnings stripping", imposed by Article 212 of the French tax code or any substantially similar successor statute, will not be considered contrary to the non-discrimination rules of this Article as long as they are applied consistently with the arm's length standard described in paragraph 1 of Article 9 (Associated Enterprises). The negotiators agreed that a similar proviso is not necessary on the U.S. side, since the U.S. rules against "earnings stripping" imposed under Code section 163(j) were designed to be consistent with the arm's length standard.

Paragraph 4 prohibits a Contracting State from subjecting an enterprise of that State that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State to taxation or connected requirements that are other or more burdensome than the taxation or connected requirements imposed on other similar enterprises in the first State.

As in the case of its other treaties, the United States takes the position that the provisions of Code section 367(e)(2) regarding the taxation of corporations on certain distributions in liquidation to foreign parent corporations are not contrary to paragraph 4 of the Article. It takes the same position with respect to its rules providing that a corporation with nonresident alien shareholders is not eligible to make an election to be an "S" corporation.

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 Contracting State or by a political subdivision or local authority thereof. Customs duties are not considered to be taxes for this purpose.

The saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions) does not apply to this Article, by virtue of the exceptions in paragraph 3 of Article 29. Therefore, a U.S. citizen who is resident in France may claim protection against discrimination 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, as defined in subparagraph 1(h) of Article 3 (General Definitions), 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 possible use of arbitration to resolve disputes that cannot be settled by the competent authorities.

Paragraph 1 provides that, where a person considers that the actions of one or both Contracting States will result for him in taxation 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 the taxpayer to have fully exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities. The paragraph provides that a case must be presented to the competent authorities no later than three years from the notification of the assessment which gives rise to the taxation not in accordance with the provisions of the Convention. The three-year period begins to run when the later formal notification of the assessment is issued. Thus, if the Internal Revenue Service makes a section 482 adjustment to a taxpayer's 1994 return and in 1996 sends the statutory notice of deficiency that results in double taxation, the taxpayer has until 1999 to present his case to the competent authority. When the case results from the combined action of the tax authorities in the two Contracting States, the three-year period begins to run when the formal notification of the second action is given.

Paragraph 2 provides that, if the competent authority of the Contracting State to which the case is presented considers the case to have merit but cannot reach a unilateral solution, it shall seek agreement with the competent authority of the other Contracting State so as to avoid taxation not in accordance with the Convention. 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. Because, under paragraph 1 of Article 29 (Miscellaneous Provisions), 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. The paragraph includes a non-exhaustive list of examples of matters about which the competent authorities may reach agreement. They may agree to the same attribution of profits between a company resident in one Contracting State and its permanent establishment in the other

Contracting State, to the same allocation of income, deductions, credits, or allowances between a company resident in one Contracting State and an associated enterprise, and to common rules as to the source of items of income. In each case, the agreement may refer to a past or future, as well as to the current, tax year. This permits, for example, entering into advance pricing agreements. They may also agree to adjust the money amounts referred to in Articles 17 (Artistes and Sportsmen) and 21 (Students and Trainees) to reflect economic or monetary developments, such as changes in the cost of living.

If cases arise that are not covered by the Convention but that would result in double taxation of income, the competent authorities may also seek to resolve those issues to avoid the double taxation. 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 France. Since no resident of a Contracting State 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 the double taxation.

Paragraph 4 provides that the competent authorities or their representatives may meet or otherwise communicate directly with each other for the purpose of reaching agreement under this Article. Agreements reached by the competent authorities under this paragraph need not conform to the domestic law provisions of either Contracting State.

Paragraph 5 introduces an arbitration procedure based on the comparable provision in the U.S. income tax treaty with Germany. It provides that, where the competent authorities have been unable to resolve a disagreement regarding the application or interpretation of the Convention, the disagreement may be submitted for arbitration, by mutual consent of the competent authorities and the taxpayer. Nothing in the provision requires that a 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, as well as on the taxpayer, with respect to that case. The arbitration procedures, including the composition of the arbitration board, shall be agreed upon in diplomatic notes to be exchanged after consultation between the competent authorities. It is expected that such procedures will ensure that arbitration will not generally be available where matters of either State's tax policy or domestic law are involved. This paragraph shall not apply until the date specified in such notes. A principal purpose of deferring the effective date of this provision is to permit the evaluation of relevant experience, such as under the U.S. convention with Germany.

Article 27. 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 France concerning the taxes covered by the Convention. For this purpose, the Convention covers all taxes imposed at the national level. 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. However, exchange of information with respect to domestic law is authorized only insofar as the taxation under those domestic laws is not contrary to the Convention.

Paragraph 1 states that information exchange is not restricted by Article 1 (General Scope). This means, for example, that information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For instance, if a third-country resident has a permanent establishment in France that engages in transactions with a U.S. enterprise, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Similarly, if a third-country resident maintains a bank account in France, 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 France 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. Information received may be disclosed only to persons, including courts and administrative bodies, concerned with the assessment, collection, administration, enforcement, prosecution, or determination of appeals in respect of the taxes covered by the Convention (within the meaning of paragraph 5 of this Article) to which the information 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. Information may be received and used by these bodies only in the performance of their role in overseeing the administration of U.S. tax laws. Information received 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 does that paragraph require a Contracting State to supply information not obtainable under the laws or administrative practice of either State or 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 domestic law, provide information that it is not obligated to provide under the provisions of this paragraph.

Paragraph 3 contemplates that the exchange of information may be on a routine basis, by specific request concerning a particular case, or the spontaneous exchange of information that comes to the attention of one competent authority and is believed to be of use to the other competent authority. There is an active exchange of information between the French and U.S. competent authorities, involving each of these kinds of exchanges, under the 1967 Convention.

Paragraph 4 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 unedited original documents) so that the information is usable in the judicial proceedings of the requesting State. The requested State shall, if possible, 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.

Subparagraph 4(c) confirms that representatives of either Contracting State will be permitted to enter the other State to interview taxpayers and review and copy records, provided that the taxpayers involved and the competent authority of the requested State consent in any given case. The subparagraph further provides that such inquiries will not be considered audits for purposes of French tax law. French law does not presently permit on-site audits by foreign tax officials. The U.S. negotiators did not believe it appropriate for such a restriction to apply unilaterally. Accordingly, the implementation of this provision requires an exchange of diplomatic notes in which both States agree to allow such inquiries on a reciprocal basis.

Paragraph 5 states that the exchange of information may pertain to all taxes imposed by the national government. Customs duties are not considered taxes for this purpose. Information

with respect to taxes imposed by political subdivisions may only be exchanged to the extent that it is relevant to determining the national taxes covered (e.g., verifying the deduction of a State income tax from income subject to Federal income tax).

Article 28. ASSISTANCE IN COLLECTION

This Article provides for limited mutual assistance in the collection of taxes covered by the Convention. It was introduced in the original U.S.-France income tax treaty, signed in 1939, and has remained substantially unchanged since that time.

Paragraph 1 provides the basic agreement that each Contracting State will assist the other in the collection of taxes to which the Convention applies, plus interest, costs, and additions to those taxes and related fines that are not penal in character. This assistance will be furnished with respect to revenue claims that have been finally determined and are definitively due, according to the laws of the requesting State.

In such cases, as provided in paragraph 2, the requested State will accept the revenue claim of the requesting State as if it were its own, and will enforce it and collect the tax due in the same manner as permitted under its laws with respect to its own revenue claims.

Paragraph 3 requires the requesting State to provide the requested State with copies of any documentation required under the laws of the former State to establish that the revenue claims have been finally determined.

Paragraph 4 provides that, when the revenue claim has not been finally determined, the requested State will take whatever measures of conservancy are authorized under its laws for the enforcement of its own taxes.

Paragraph 5 provides that the assistance authorized by this Article will not be granted with respect to citizens, companies, or other entities of the requested State. An exception is made if the competent authorities of the two States agree that a reduction of tax granted to such a person under the Convention has been enjoyed by a person or persons not entitled to such benefits, or in the case of France, where the dividend tax credit "avoir fiscal") provided for in paragraph 4 of Article 10 Dividends) to a U.S. citizen, company, or other entity, has been enjoyed by some other person not intended to benefit from that provision. This exception is new to the Article. It is consistent with the intent of the Contracting States to limit treaty benefits to qualified persons, as expressed in Article 30 (Limitation on Benefits of the Convention) and of the articles of other recent U.S. tax conventions with respect to limitations on benefits.

Article 29. MISCELLANEOUS PROVISIONS

Paragraphs 1 through 3 of this Article cover provisions typically found in Article 1 of U.S. income tax treaties, concerning the relationship between the Convention and domestic tax laws, the saving clause permitting domestic law taxation of residents and citizens, and exceptions to the saving clause. Paragraphs 4 though 7 contain assorted provisions that do not fit squarely in any other article. Paragraph 8 also relates to paragraph 1 and concerns the relationship between the convention and other international agreements.

Subparagraph 1(a) establishes that the Convention does not create an independent U.S. taxing right in cases where domestic tax law does not provide such a right. No provision in the Convention may restrict any benefit accorded by the Code. Thus, for example, if a deduction would be allowed under the Code in computing the taxable income of a resident of France, the deduction will be available to that person in computing income under the treaty. In addition, a right to tax given by the treaty cannot be exercised by the United States unless that right also exists under the Code. A taxpayer may always rely on the Code treatment. In the case of France, this rule applies with respect to U.S. citizens and residents, with certain exceptions. In France, a treaty takes precedence over domestic law. Thus, France was concerned that agreeing to this rule could cause unintended results in some cases. The exceptions are intended to preserve the French statutory right to tax when the Convention provides for exemption in the United States (e.g., in the case of certain teachers who are U.S. citizens resident in France) or to prevent double benefits under French domestic law and the Convention (e.g., in the case of double taxation relief).

A taxpayer may not, in any case, pick and choose among Code and treaty provisions in an inconsistent manner in order to minimize tax. For example, assume a resident of France has three separate businesses in the United States, one a permanent establishment under the Convention, and the other two trades or businesses under the Code but not permanent establishments under the Convention. The permanent establishment is profitable, one of the other businesses is profitable, and the other incurs a loss. Under the Convention, the income of the permanent establishment is subject to U.S. tax but 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 against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B. 308.) However, 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

U.S. source dividend income that is not effectively connected with any of his business activities in the United States.

Subparagraph 1(b) establishes that the Convention will not restrict any benefit provided under another agreement between the Contracting States. Paragraph 8 modifies that rule with respect to certain obligations undertaken by the Contracting States under other agreements. Paragraph 8 provides that, notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning whether a measure falls within the scope of this Convention shall be considered only by the competent authorities of the Contracting States as defined under subparagraph 1(h) of Article 3 (General Definitions), and the procedures under this Convention exclusively shall apply to the dispute. Thus, dispute resolution procedures provided in trade, investment, or other agreements between the Contracting States shall not apply for the purpose of determining the scope of the Convention.

Paragraph 8 further provides that, unless the competent authorities agree that a taxation measure is not within the scope of this Convention, the nondiscrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favored-nation ("MFN") obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade ("GATT"). No national treatment or MFN obligation under any other agreement shall apply with respect to that measure. Thus, any national treatment and MFN obligations undertaken by the Contracting States under agreements other than the Convention shall not apply to a taxation measure, with the exception of GATT as applicable to trade in goods. For purposes of paragraph 8, a "measure" is defined as a law, regulation, rule, procedure, decision, administrative action, or any other form of measure.

Paragraphs 2 and 3 of Article 29, concerning the saving clause, are discussed in connection with Article 1 (Personal Scope).

Paragraph 4 provides that there shall not be imposed a stamp tax or similar transaction tax on the trading of stocks or securities on a stock exchange in a Contracting State when the order for purchase, sale, or exchange originates in the other Contracting State. This provision replaces paragraph 5 of Article 22 of the 1967 Convention, which similarly exempted from the French tax on stock exchange transactions those transactions that originate in the United States. In addition, because the French tax was a covered tax under the 1967 Convention, it also could not be imposed on any transaction originated by a U.S. resident outside of the United States (unless there was a permanent establishment or fixed base in France). Although the French tax is not a covered tax under the new treaty, France has

amended its law and now exempts all transactions entered into by nonresident individuals and foreign corporations, both for domestic law and treaty purposes. The current treatment will, therefore, continue to apply even in the rare case of a transaction originated by a U.S. resident outside of the United States.

Paragraph 5 prohibits a Contracting State from imputing income to a resident of the other Contracting State based on the rental value of housing that the resident owns in the first-mentioned State. This provision, which appeared as paragraph 5 of Article 23 of the 1967 Convention, relates to a provision of French tax law (Article 164 of the General Tax Code) that permits France to impose tax in certain circumstances on a multiple of the rental value of housing, if that is greater than reported income.

Paragraph 6 permits the United States to impose its statutory rate of tax (currently 30 percent) on an excess inclusion with respect to a residual interest of a French resident in a real estate mortgage investment conduit, notwithstanding the rule of Article 11 (Interest) that generally exempts interest from taxation at source.

Paragraph 7 incorporates two provisions formerly included in a 1978 exchange of letters. Both provide French tax benefits to U.S. citizens resident in France. First, income other than capital gain arising from the exercise of stock options with respect to shares of U.S. companies will be taxable income in France when and to the extent that it is treated as ordinary income for U.S. tax purposes. Second, U.S. state and local income taxes paid with respect to personal service income and other business income (except certain business income exempt from French income tax) will be deductible as business expenses in computing French income tax.

Paragraph 8 is discussed above in connection with subparagraph 1(b).

Article 30. LIMITATION ON BENEFITS OF THE CONVENTION

Article 30 addresses the problem of "treaty shopping" by limiting the source basis tax benefits of the Convention to those residents of the other Contracting State that have a substantial business nexus with, or otherwise have a significant business purpose for residing in, the other Contracting State. In a typical case of treaty shopping, 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 treaty benefits with respect to that income. Article 30 limits the Convention to those persons whose residence in a Contracting State is unlikely to have been motivated by the

existence of the Convention. Absent Article 30, the entity generally would be entitled to benefits under the Convention as a resident of a Contracting State, although the entity might be denied those benefits as a result of limitations (*e.g.*, business purpose, substance-over-form, step transaction or conduit principles or other anti-avoidance rules) applicable to the transaction or arrangement under the domestic law of the source State. Article 30 and the anti-abuse provisions of domestic law complement each other, as Article 30 generally determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions determine whether a particular transaction should be recast in accordance with the substance of the transaction.

The structure of the Article is as follows: Paragraph 1 lists a series of attributes, any one of which will make the person a resident entitled to the benefits of the Convention in the other Contracting State. These are essentially objective tests. Paragraph 2 introduces an alternative test, under which a resident of a Contracting State that does not qualify under paragraph 1 may claim treaty benefits with respect to those items of income connected with the active conduct of a trade or business in the other Contracting State. Paragraph 3 provides that benefits are available to a resident of a Contracting State that is a headquarters company for a multinational corporate group, as defined in subparagraph 6(h). Paragraph 4 provides for limited so-called "derivative benefits" with respect to dividends, interest, and royalties to a company resident in the other Contracting State that satisfies modified ownership and base erosion tests in which ownership by residents of member states of the European Union is taken into account. Paragraph 5 limits treaty benefits in certain "triangular" cases. Paragraph 6 defines terms used in this Article. Paragraph 7 provides that the benefits of the Convention shall be allowed to a resident of a Contracting State that does not satisfy any of the preceding paragraphs if the competent authority of the other Contracting State decides, on the basis of certain factors, that benefits should be granted in that case. Paragraph 8 provides that the competent authorities of the two States may consult together on the application of this Article.

Under paragraph 1, the first two categories of persons that qualify for Convention benefits are (1) individual residents of a Contracting State, and (2) the Contracting States, political subdivisions (in the case of the United States) or local authorities thereof, or agencies or instrumentalities of such a State, subdivision, or authority. It is most unlikely that persons falling into these two categories can be used to derive treaty-benefitted income, as the beneficial owner of the 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 that grant the benefit, because of the requirements in those articles that the beneficial owner of the income be a resident of a Contracting State.

Under subparagraph 1(c)(i), a company 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 its principal class of shares on one or more recognized stock exchanges. The term "recognized stock exchange" is defined in subparagraph 6(e) to mean, in the United States, the NASDAQ System and any stock exchange registered as a national securities exchange with the Securities and Exchange Commission, and, in France, the French stock exchanges controlled by the "Commission des operations de bourse." In addition, the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, London, Madrid, Milan, Sydney, Tokyo, and Toronto are recognized stock exchanges, and the competent authorities are authorized to add other stock exchanges on which they both agree.

Under subparagraph 1(c)(ii), a company will qualify for benefits, even if its own shares are not publicly traded, if more than 50 percent of the aggregate vote and value of its shares is owned, directly or indirectly, by any combination of the following categories of persons: (1) publicly traded companies that satisfy subparagraph 1(c)(i); (2) the governments, agencies, or instrumentalities referred to in subparagraph i(b); and (3) any companies of which persons referred to in subparagraph 1(b) own more than 50 percent of the aggregate vote and value of the shares.

Under subparagraph 1(c)(iii), a company will qualify for benefits if it satisfies an alternative ownership test. The alternative test is comprised of two parts. The first part is the same as that of subparagraph 1(c)(ii), except that "more than 50 percent" is lowered to "at least 30 percent." The second part requires that there be sufficient ownership, directly or indirectly, by any combination of specified owners to bring the total ownership under the two parts to at least 70 percent of the aggregate vote and value of the company's shares. The specified owners are: (1) publicly traded companies that are residents of either Contracting State or of one or more member states of the European Union; (2) the Contracting States, political subdivisions (in the case of the United States) or local authorities thereof, or agencies or instrumentalities of such a State, subdivision, or authority; (3) companies of which more than 50 percent of the vote and value of the shares is owned by: (a) the Contracting States, political subdivisions (in the case of the United States) or local authorities thereof, agencies or instrumentalities of such a State, subdivision, or authority, (b) member states of the European Union, political subdivisions or

local authorities thereof, or agencies or instrumentalities of such member states, subdivisions or authorities; or (c) companies more than 50 percent owned by the member states of the European Union, political subdivisions or local authorities thereof, or agencies or instrumentalities of such member states. This subparagraph recognizes that there may be, particularly within regional groupings like the European Union, joint ventures between private and government owners from different countries that should be entitled to treaty benefits because the purpose of their multi-country ownership is not to derive tax treaty benefits but to accomplish an international business purpose.

If benefits are sought under subparagraph 1(c)(i) or (ii) in a case involving indirect ownership, all companies in the chain of ownership must be residents of a Contracting State or of a member state of the European Union, as defined in subparagraph . 6(d). This requirement is stated in subparagraph 6(a).

For purposes of subparagraph 1(c)(iii) and elsewhere in this Article, references to a "resident of a member state of the European Union" mean a person that would be entitled to the benefits of a comprehensive income tax convention in force between that member state of the European Union and the United States (when the United States is the State providing benefits) under a comprehensive limitation on benefits article that includes provisions similar to those of subparagraphs 1(c) and 1(d) and paragraph 2 of this Article. If there is no such convention or if it does not contain such a comprehensive limitation on benefits article, the person must be a person that would be entitled to the benefits of this Convention under paragraph 1 if such person were a resident of France or the United States, as applicable.

Subparagraph 1(d) provides another two-part test, referring to ownership and "base erosion," both parts of which must be met for entitlement to benefits under this subparagraph. Under the ownership portion, benefits will be granted to a resident of a Contracting State other than an individual if less than 50 percent of the beneficial interest in the person (or, in the case of a corporation, less than 50 percent of the vote and value of each class of its shares) is owned, directly or indirectly, by persons who are not entitled to benefits under the tests of paragraph 1 and are not U.S. citizens. For example, if the shares of a French company are more than 50 percent owned by another French company that is wholly owned by residents of a third country that are not U.S. citizens, that French company would not pass the ownership test, because more than 50 percent of its shares is indirectly owned by the third-country residents.

The second or "base erosion" part of this test itself has two parts, of which it is sufficient to satisfy either one. Either (a) less than 50 percent of the person's gross income may

be used, directly or indirectly, to make deductible payments to persons that are not eligible for benefits under the tests of paragraph 1 and are not U.S. citizens, or (b) less than 70 percent of such gross income may be used to make deductible payments to persons mentioned in (a) and less than 30 percent may be used to make deductible payments to persons that are neither mentioned in (a) nor residents of member states of the European Union.

The rationale for the two-part test of subparagraph 1(d) 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, insurers and reinsurers, and others), simply requiring substantial ownership of the entity by treaty country residents or U.S. citizens will not prevent such benefits from inuring substantially to third-country residents. It is also necessary to require that the entity's deductible payments be made in substantial part to treaty country residents or to U.S. citizens. For example, a third-country resident could lend funds to a French-owned French corporation to be reloaned to the United States. The U.S. source interest income of the French corporation would be exempt from U.S. withholding tax under Article 11 (Interest) of the Convention. While the French corporation would be subject to French corporation 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 France and the third country, that interest is exempt from French tax, the U.S. treaty benefit with respect to the U.S. source interest income will have flowed to the third-country resident inappropriately, with no reciprocal benefit to the United States from the third country.

Subparagraphs 1(e) and 1(f) provide that pension organizations, not-for-profit organizations, and certain investment entities that are residents of a Contracting State under Article 4 (Resident) are entitled to benefits from the other Contracting State if more than half of their beneficiaries, members, participants, or owners are persons entitled, under this Article, to the benefits of the Convention. Note that, under paragraph 4(b)(iii) of Article 10 (Dividends), a regulated investment company must satisfy a more stringent test, requiring that at least 80 percent of the investors be U.S. residents or citizens, to qualify for the benefit of the French tax credit ("avoir fiscal") provided in that paragraph. If a RIC were to meet the test of this paragraph of Article 30, but not the test of subparagraph 4(b)(iii) of Article 10, it would nevertheless be eligible for the benefits of paragraph 2 of Article 10.

The provisions of paragraph 1 are intended to be self-executing. Unlike a claim under the provisions of paragraph 7, discussed below, a claim of benefits under this paragraph 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 paragraph and is not entitled to the benefits claimed.

Paragraph 2 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 that activity. This is the so-called "active trade or business" test. Under this test, a resident of a Contracting State deriving income from the other Contracting State is entitled to the benefits of the Convention with respect to that income if the person is engaged in an active trade or business (as defined in subparagraph 6(g)) in his State of residence, the item of income in question is derived in connection with, or is incidental to, that trade or business, and that trade or business is substantial in relation to the income-generating activity in the other State.

The business of making or managing investments will not be considered an active trade or business for the purposes of paragraph 2 unless carried on by a bank or insurance company engaged in banking or insurance activities. Income is considered derived "in connection" with an active trade or business if, for example, the activity that generates the income is "upstream," "downstream," or parallel to the active trade or business. Thus, if the U.S. activity of a French manufacturer consisted of selling its products or the same sort of products in the United States or providing inputs to the French manufacturer, the U.S. income would be considered connected with the French business. Income is considered "incidental" to a business if, for example, it arises from the short-term investment of the working capital of the business.

The determination as to whether a trade or business in one Contracting State is "substantial" in relation to the activity carried on in the other Contracting State is based on the facts and circumstances of each case.

In addition to the rule that the determination of substantiality will be made on the specific facts and circumstances, subparagraph 2(b) provides a safe harbor standard. Under the safe harbor, the activity in a Contracting State will be deemed substantial if the ratios of assets used in that State, gross income derived from that State, and payroll expense for services performed in that State to assets, gross income and payroll expense for services in the other Contracting State each exceed 7.5 percent and the average of the three ratios exceeds 10 percent. These ratios are the same as in the U.S.-Netherlands income tax treaty. The paragraph makes it clear, as does the explanation of the comparable provision in the U.S.-Netherlands treaty, that assets, gross income, and payroll expense are taken

into account in computing these ratios only to the extent that the company deriving the income has an ownership interest in the company resident in the other Contracting State that generates the income. Thus, for example, a French manufacturer that derives income from the sale in the United States through unrelated distributors of goods it produces in France will satisfy the substantiality requirement with respect to that income without the need to calculate the ratios.

Paragraph 2 is applied separately for each item of income derived by a resident of one Contracting State from the other Contracting State. It differs in this respect from paragraph 1. A resident of a Contracting State that qualifies for treaty benefits under paragraph 1 qualifies with respect to all income derived from the other Contracting State. If a person qualifies for benefits under paragraph 1, no inquiry need be made into qualification for benefits under paragraph 2.

Paragraph 3 provides that a resident of a Contracting State is entitled to the benefits of the Convention if that person functions as a headquarters company for a multinational corporate group. A person is considered a headquarters company for this purpose only if several conditions, specified in subparagraph 6(h), are satisfied. The person seeking such treatment must perform in its State of residence a substantial portion of the overall supervision and administration of the group, which may include, but cannot be principally, group financing. The person must have, and exercise, independent discretionary authority to carry out these functions. It must be subject to the same income taxation rules in its residence State as are persons engaged in the active conduct of a trade or business, as described above in connection with the active business test under paragraph 2. Because France does not presently subject headquarters companies to the same income tax rules that apply to active trades or businesses, this last requirement will prevent French headquarters companies from claiming benefits under paragraph 3 unless French law is changed in a manner that satisfies the requirements of this paragraph.

Either for the taxable year concerned, or as an average for the preceding four years, the activities and gross income of the corporate group that the headquarters company supervises and administers must be spread sufficiently among several countries. The group must consist of corporations resident in, and engaged in an active business in, at least five countries, and the income derived in the Contracting State of which the headquarters company is not a resident must be derived in connection with, or be incidental to, that active business. The business activities carried on in each of the five countries or groupings of countries must generate at least 10 percent of the gross income of the group. The business activities carried on in any one country other than the Contracting State where the headquarters

company resides may not generate 50 percent or more of the gross income of the group. Moreover, no more than 25 percent of the headquarters company's gross income may be derived from the other Contracting State.

The competent authorities may by mutual agreement determine transition rules for newly established business operations, newly established corporate groups or newly established headquarters companies. A similar provision appears in the recent United States-Netherlands income tax convention.

Paragraph 4 grants treaty benefits under Articles 10 (Dividends), 11 (Interest), and 12 (Royalties) to a company resident in one of the Contracting States that does not meet the standards of the preceding paragraphs but that does meet special ownership and base erosion tests. For this purpose, the base erosion test is the same as described in subparagraphs 1(d)(i) and (ii). The ownership test is that more than 30 percent of the aggregate vote and value of the company's shares must be owned, directly or indirectly, by qualified persons that are resident in the Contracting State of which the company is resident, and more than 70 percent of its shares must be owned, directly or indirectly, by such qualified persons, U.S. citizens, or residents of member states of the European Union (as defined in subparagraph 6(d)).

Paragraph 5 addresses the so-called "triangular case," in which a resident of France derives profits through a permanent establishment in a third country that imposes little or no income tax liability on those profits, and the profits are exempt from French tax under its territorial system of taxing business profits. The Contracting States agreed that it would be inappropriate to grant treaty benefits with respect to income derived in such a case. Therefore, paragraph 5 denies any treaty benefit if the combined tax in France and the third country is less than 60 percent of the tax that would be imposed in France if the income were earned there and were not attributable to the permanent establishment in the third country. Paragraph 5 further provides that any dividends, interest, or royalties derived in such a case shall be subject to a tax at source under domestic law, but at a rate not exceeding 15 percent of the gross amount. The paragraph is drafted reciprocally, but has no application with respect to the United States, because the United States does not exempt the profits of a U.S. company attributable to its foreign permanent establishments.

In the case of a French resident with a permanent establishment in a third country, the provisions of paragraph 5 do not apply if the profits of the permanent establishment are taxed in the United States, _i.e._, under the subpart F provisions of the Internal Revenue Code, or in France, under the provisions of section 209B of the French tax code. (The reference to

subpart F was intended to refer to subpart F of part III of subchapter N of chapter 1 of subtitle A of the Internal Revenue Code.) It was considered appropriate to take the subpart F provisions into account because of the restrictions on abuse under French domestic law.

Nor do the provisions of paragraph 5 apply if the income derived from the other Contracting State is derived from an active trade or business in the third country. The business of making or managing investments is not an active trade or business for this purpose unless the activities are banking or insurance activities carried on by a bank or insurance company.

Paragraph 6 defines key terms used in this Article, most of which are discussed above in connection with the relevant paragraphs.

Paragraph 7 provides that a resident of a Contracting State that does not otherwise qualify for the benefits of the Convention under this Article may nevertheless request that the competent authority of the other Contracting State grant it the benefits of the Convention. If the competent authority of the other Contracting State determines that the establishment, acquisition, or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention, or that it would be inappropriate to deny the benefits of the Convention to such person, it is required to grant benefits in that case. The competent authority will consult with the competent authority of the other State before denying benefits under this paragraph. It is anticipated that, in making its determination, the competent authority will take into account such factors as those enumerated in the Understanding to Article 26 of the U.S.-Netherlands Convention concerning the corresponding provision of that Article.

Paragraph 8 provides additional authority to the competent authorities (in addition to that of Article 26 (Mutual Agreement Procedure)) to consult together to develop a common application of the provisions of this Article.

Article 31. DIPLOMATIC 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.

If, however, because of such privileges, income or capital is not taxed in the receiving State, paragraph 2 grants to the sending State the right to tax the income or capital.

Under paragraph 3, an individual who is a member of a diplomatic mission or consular post of a Contracting State, whether situated in the other Contracting State or in a third country, will be deemed to be a resident of the sending State if two conditions are met: (1) in accordance with international law, the individual is not subject to tax in the receiving State in respect of income from sources outside that State or in respect of capital situated outside that State, and (2) the individual is liable to tax in the sending State on worldwide income and capital in the same manner as 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 (Residence).

The saving clause of paragraph 2 of Article 29 does not apply to benefits available under this Article to an individual who is neither a citizen of, nor has immigrant status in, the United States.

Article 32. PROVISIONS FOR IMPLEMENTATION

This Article establishes that the competent authorities may prescribe rules and procedures, jointly or separately, for the implementation of the provisions of the Convention, such as the reduced withholding taxes at source on dividends, interest, and royalties beneficially owned by a resident of the other Contracting State.

Paragraph 2 specifically authorizes a Contracting State to require residents of the other State claiming the benefits of the Convention to present a form including the relevant information, such as the type and amount of income or capital and the residence of the taxpayer. The competent authorities may also require certification by the tax administration of the residence State, in an agreed form and manner. Such certification might consist of confirming that the beneficial owner of the income filed a return and paid tax as required of a resident of that State.

The procedures described above will be implemented by competent authority agreement pursuant to Article 26 (Mutual Agreement Procedure). The competent authorities may also establish, either unilaterally or by mutual agreement, other procedures for the implementation of the provisions of the Convention.

This Article was included at the request of France. Such procedures are considered by the United States to be implicitly authorized by treaties, but France preferred to include an explicit authorization.

Article 33. ENTRY INTO FORCE

Article 33 provides that the Contracting States will notify each other when their constitutional and statutory requirements for the entry into force of the Convention have been completed. For the United States, the delivery of the signed instrument of ratification constitutes such notice. On the date of receipt of the later of such notifications, the Convention will enter into force.

Once the Convention is in force, its taxing provisions take effect as of different dates. In general, the provisions concerning taxes withheld at source on dividends, interest, and royalties, and the U.S. excise tax on insurance premiums paid to foreign insurers, will be effective for amounts paid or credited on or after the first day of the second month after entry into force. For example, if the Convention enters into force on June 30, 1995, those provisions will apply for amounts paid or credited on or after August 1, 1995. However, as mentioned in subparagraph 3(a), the provisions of paragraph 4 of Article 10 (Dividends), concerning the French dividend tax credit, have effect for dividends paid or credited on or after January 1, 1991. Similarly, the provisions of Article 12 (Royalties) have effect for royalties paid or credited on or after January 1, 1991. The latter rule does not affect U.S. taxation of royalties, since it has been consistent with the current wording.

For other income taxes, the Convention is effective for taxable periods beginning on or after the first day of January of the year after entry into force. In the above example, that would be January 1, 1996. For other taxes, e.g., the French wealth tax or the French tax on stock exchange transactions, the Convention applies to taxable events occurring on or after the first day of January of the year following entry into force.

As explained in subparagraph 3(b), the provisions of Article 26 (Mutual Agreement Procedure) apply with respect to any cases presented to the competent authorities after the Convention enters into force, even if the cases involve taxable periods prior to the entry into force. This is consistent with the usual U.S. and French positions on this point.

The provisions of the 1967 Convention, and the four subsequent protocols and accompanying exchanges of letters that amended that Convention, will cease to have effect from the date on which the corresponding provisions of this Convention take effect.

Article 34. TERMINATION

The Convention will remain in effect indefinitely unless it is terminated by one of the Contracting States in accordance with

the provisions of this Article. Either Contracting State may terminate the Convention at any time after five years from the date on which it enters into force, provided that notice has been given through diplomatic channels at least six months before the end of a calendar year. In such case the provisions of the Convention generally will cease to apply as of the following January 1. The requirement of six months' notice before the end of a calendar year is unchanged from the 1967 Convention.

If notice of termination is given as described above, the provisions of the convention concerning taxes withheld at source on dividends, interest, and royalties, and the U.S. excise tax on insurance premiums paid to foreign insurers, will cease to apply for amounts paid or credited on or after the first day of January following the expiration of the six-month period. The provisions concerning other taxes will cease to apply: (1) in the case of taxes on income, for taxable periods beginning on or after the first day of January following the six-month period, and (2) in the case of other taxes, for taxable events occurring on or after the first day of January following the six-month period.

EXCHANGE OF DIPLOMATIC NOTES

Two exchanges of diplomatic notes accompany the Convention and explain certain points of the Convention. Those points are discussed above in connection with the provisions to which they relate.

TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE UNITED STATES OF AMERICA AND UKRAINE FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL SIGNED AT WASHINGTON ON MARCH 4, 1994

INTRODUCTION

This is a technical explanation of the Convention and Protocol between the United States and Ukraine signed on March 4, 1994 ("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 Ukraine.

The Convention is based on the Model Double Taxation Convention on Income and Capital, published by the OECD in 1992 ("the OECD Model"), the 1973 Convention and other more recent US income tax conventions.

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 Ukraine, and in some cases may also apply to residents of third States. Article 4 defines residents of the United States and Ukraine 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 provides that 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 Ukraine 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 that is not effectively connected with any of his business activities in the United States.

Under subparagraph 2 b), the Convention also may not restrict a tax benefit conferred by any other agreement between the Contracting States. Under notes exchanged between the Contracting States on June 6, 1995 ("the Notes"), the Contracting States have agreed to a provision that specifically addresses on the relationship of the Convention to other agreements, including the General Agreement on Trade in Services ("GATS").

The United States is a party to "GATS" but Ukraine is not. Nevertheless, the Contracting States have considered the relationship between the Convention and GATS in the event that GATS should apply between them.

Article XXII(3) of GATS provides that a Member of the World Trade Organization may not invoke the obligation of national treatment under Article XVII of GATS with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation. In the case of a dispute between Members as to whether a measure falls within the scope of such an agreement between them, Article XXII(3), footnote 11 of GATS provides that, with respect to agreements on the avoidance of double taxation which exist on the date of entry into force of the WTO Agreement, the dispute may be brought before the Council for Trade in Services only with the consent of both parties to such an agreement.

Paragraph 1 of the Notes provides that, notwithstanding Article XXII(3) and footnote 11 of the GATS, in the event that the GATS applies between the Contracting States, a dispute concerning whether a measure is within the scope of the proposed Convention shall be considered only pursuant to Article 26 (Mutual Agreement Procedure) of the proposed Convention by the competent authorities as defined in subparagraph 1(j) of Article 3 (General Definitions) of the proposed Convention.

In addition, the Contracting States have considered the relationship between the Convention and other agreements that apply between them and that have provisions concerning national treatment or most-favored-nation treatment. Paragraph 2 of the Notes provides that, unless the competent authorities determine that a taxation measure is not within the scope of the proposed Convention, the national treatment or most-favored-nation ("MFN") obligations under any other agreement (including GATS in the event that it applies between the Contracting States) shall not apply to a taxation measure, subject to certain exceptions. These exceptions permit the application of such national treatment or MFN obligations as may apply to trade in goods under the Agreement on Trade Relations between the United States and Ukraine, and the General Agreement on Tariffs and Trade ("GATT"), if it applies between the United States and Ukraine.

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 own residents, and in the case of the United States, its 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 Ukraine under Ukrainian law, and the tie-breaker rules of paragraph 2 of Article 4 determine that he is a resident of Ukraine, he will be entitled to U.S. benefits under the Convention. The paragraph also permits the taxation of certain former citizens by the United States whose loss of citizenship had as one of its principal purposes the avoidance of

U.S. tax, in accordance with section 877 of the Internal Revenue Code. There is not a comparable provision in Ukrainian 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 Ukrainian taxation of Ukrainian 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 that is provided in paragraph 1 of Article 19, 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. Under subparagraph b) certain additional benefits are available to U.S. residents who are neither US citizens nor "green card" holders; these are the benefits extended to employees of the Ukrainian Government under Article 18, to visiting students, trainees and researchers under Article 20, and to members of diplomatic and consular missions under Article 28. This paragraph also applies reciprocally.

Article 2. TAXES COVERED.

This Article identifies the U.S. and Ukrainian 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 25 apply to all taxes imposed at all levels of government. It is the only article that applies to state and local taxes. The exchange of information provisions of Article 27 apply to all Federal level taxes, 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 Ukraine, the Convention applies to the taxes on profits and income provided by the enumerated Ukrainian laws. The non-discrimination provisions of Article 25 extend to all taxes at all levels of government and the exchange of information provisions of Article 27 extend to all national-level taxes.

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 March 4, 1994 (the date of signature of the Convention). In recognition of the fact that the Ukrainian 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 property subsequently imposed by either Contracting State.

Paragraph 2 also provides that the U.S. and Ukrainian competent authorities will notify each other of significant changes in their taxation laws that are of significance to the operation of the Convention, including changes that deny or have the effect of denying deductions for interest, wages and other significant business expenses.

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 Ukraine, depending on the context in which the term is used.

The terms "United States" and "Ukraine" 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, and any area outside the territorial sea that in accordance with international law has been or may be designated an area in which the United States may exercise rights with respect to the seabed and subsoil and their natural resources.

When used geographically the term "Ukraine" includes the territorial sea, and any area outside the territorial sea that in accordance with international law has been or may be designated an area in which the United States may exercise rights with respect to the seabed and subsoil and their natural resources.

Subparagraph d) defines the term "national" to include any individual possessing the nationality of a Contracting State, and

any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.

Subparagraph e) defines the term "person" to include an individual, an estate, a trust, a partnership, a company and any other body of persons. 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 f) as any entity treated as a body corporate for tax purposes. In Ukraine, 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 Ukraine. For U.S. tax purposes, the rules of Treas. Reg. § 301.7701-2 generally will be applied to determine whether an entity is a body corporate. However, Ukrainian entities described in the second sentence of subparagraph **f)** are treated as companies for all purposes of the treaty.

Subparagraph g) 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 Ukrainian 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 7 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 Ukrainian airplane from Kiev 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 h) defines the term "property." The definition is relevant for possible future enactment of a tax on capital by either Contracting State. (See Article 23 (Property).)

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" are defined in subparagraph i) 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 "competent authority" is the Government official 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 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 Ukraine, 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 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 22 (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. Consistent with U.S. treaty policy, the 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 Ukraine 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. A 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 a 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 the Convention.

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 State for purposes of the Convention. Thus, for example, a Ukrainian 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.)

Paragraph 1 of the Protocol provides that 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 Ukrainian 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 Treas. 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 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.

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 applies if 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 provides that if a person, other than an individual, is a resident of both Contracting States under their respective laws, the competent authorities will attempt to 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 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 which the recipient has in the source State; if the income is or was attributable to a permanent establishment, Article 7 (Business Profits) applies (and if the income is or was attributable to a fixed base, Article 14 (Independent Personal Services) applies).

This Article is similar in most respects to the corresponding Article of the OECD Model.

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 either wholly or in part 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 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 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 6 months. Although shorter than the period provided in some recent treaties, such as the treaty with the Russian Federation, this period is longer than the period provided in some other treaties with less-developed states, such as the 120 day period provided in the tax treaty with India. This period therefore may be considered to be consistent with recent U.S. treaty policy in treaties with developing countries. Further, pursuant to Article 29 (Entry into Force), during the first taxable year in which the Convention is in effect, a taxpayer may claim the benefit of the longer period provided in the 1973 Convention (but only beyond the end of that first taxable year to the extent consistent with the six month period provided in the Convention).

The 6-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 6-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 6 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. 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. 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, 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. The term does not include ships, boats and aircraft.

Paragraph 3 clarifies that the Article covers income from any use of real property, without regard to the form of exploitation, including leasing or sub-leasing.

Paragraph 4 is based on a corresponding provision in the OECD Model, clarifying that paragraphs 1 and 3 of this Article also apply to income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Paragraph 5 provides for a binding election by the taxpayer to be taxed on a net basis. The election reflects U.S. treaty policy and U.S. law. Since this Article provides for net basis taxation, it generally provides the same tax result as Article 7 (Business Profits).

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 under paragraph 1 is that business profits (as defined in paragraph 6) 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 2 of the Protocol to the Convention provides an example of the "attributable to" concept. The example concerns a company that is engaged in oil production through 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 6 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.

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, and dealing wholly independently with the enterprise of which it is a permanent establishment and any other enterprise that is an associated enterprise within the meaning of Article 9

(Associated Enterprises). 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), 14 (Independent Personal Services) and 21 (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 Ukrainian 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 for the purposes of the permanent establishment. Allocable expenses 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. As indicated in paragraph 2(b) of the Protocol, the expenses may be incurred by the home office of the permanent establishment, other permanent establishments in third countries, or the permanent establishment itself. 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. In no case, however, will deductions be allowed for amounts paid by the permanent establishment to the home office or other permanent establishments in respect of deductible expenses such as interest, royalties, and service fees. Rather, the permanent establishment will be allowed deductions for such expenses only to the extent they are reasonably allocable to the permanent establishment, as described above.

Paragraph 4 provides that the business profits attributable to a permanent establishment shall be determined by the same method from year to year unless there is a good and sufficient reason to the contrary.

Paragraph 5 provides that no business profits will be attributed to a permanent establishment merely because it purchases goods or merchandise for the resident 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 6 illustrates the meaning of the term "business profits" as used in this Article. It includes income from the active conduct of business, such as 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.

Paragraph 7 coordinates the provisions of this Article and other provisions of the Convention. Under paragraph 7, 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 (Business Profits). 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 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 g) 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. Gain from the alienation of containers and related equipment that are used in international traffic are exempt if such gain is incidental to income from the use or rental of such equipment. Further, gain from the alienation of ships or aircraft operated in international traffic is exempt from tax at source if such gain is incidental to income from the operation by the resident of ships or aircraft in international traffic.

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 a Ukrainian airline were to form a consortium with other national airlines, the Ukrainian participant's share of the income derived from U.S. sources would be covered by this Article.

Article 9. ASSOCIATED ENTERPRISES

This Article provides that when two related persons that are residents 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.

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 26 (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 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 3 of the Protocol (discussed below), paragraph 2 limits to 5 percent the tax imposed by the source State on direct investment dividends. A non-reciprocal definition of direct investment dividends has been adopted. In general, source state tax is limited to 5 percent if the beneficial owner of the dividend is a company resident in the other State that owns at least 10 percent of the voting stock of the paying corporation (or 10 percent of the authorized capital if the company does not have voting stock). However, in the case of dividends paid by a Ukrainian company, nonresidents of Ukraine must in total own at least 20 percent of the voting stock of the paying company (or 20 percent of the authorized capital if the company does not have voting stock) in order for the 5 percent limitation to apply. The 20 percent foreign ownership requirement may be satisfied by

any non-Ukrainian shareholder (not only U.S. shareholders). This requirement of 20 percent foreign ownership corresponds to provisions in Ukrainian law relating to foreign-owned joint ventures and eligibility for tax holidays. The United States did not insist that this requirement apply also to dividends paid by United States corporations because it is inconsistent with general U.S. treaty policy of withholding 5 percent of dividends paid to beneficial owners of 10 percent or more of the stock of the paying corporation, and it would be inconsistent with U.S. policy relating to limitation on benefits to confer an additional benefit on a 10 percent Ukrainian shareholder in a U.S. corporation only if an additional investor (potentially from a third state that is not a U.S. treaty partner) also invested in the paying corporation.

In other cases, the source State tax is limited to 15 percent of dividends beneficially owned by residents of the other State.

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 Ukrainian 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 7 (Business Profits) or Article 14 (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 Ukraine 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 3 of the Protocol 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 15-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 any company 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.

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.

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 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 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 4 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 Ukraine would be subject to the domestic rate of withholding tax, now 30 percent.

Because Article 11 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 Ukrainian company (Code section 884(f)(1)(B)).

Article 12. ROYALTIES

Paragraph 1 grants to each Contracting State the right to tax royalties derived and beneficially owned by its residents, without regard to source. Paragraph 2 permits source taxation of royalties beneficially owned by a resident of the other State at a rate not to exceed 10 percent of the gross amount of the royalties paid.

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 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 scientific 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. Such gain is taxable only in the State in which the alienator is

resident under Article 13 (Gains from the Alienation of Property). Income from the leasing of tangible personal property is taxed under Article 7 (Business Profits).

Paragraph 4 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 7 (Business Profits) or Article 14 (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 5 provides a rule for determining the source of royalties. Royalties will be deemed to arise in a State if the payor is a resident of that State (including the State itself or a political subdivision thereof). However, if the payor has a permanent establishment or fixed base in a Contracting State, the liability to pay the royalties was incurred in connection with such permanent establishment or fixed base, and the royalties are borne by the permanent establishment or fixed base, the royalties will be considered to arise in the State in which the permanent establishment or fixed base is situated. Finally, if this rule does not operate to deem royalties as arising in either State, and the royalties relate to the use of intangible property (as defined in paragraph 3), they shall be deemed to arise in the State in which they are used. This source rule also applies for purposes of Article 24 (Relief from Double Taxation).

Paragraph 6 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 Ukraine, 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. GAINS FROM THE ALIENATION OF PROPERTY

Article 13 provides rules for source and residence country taxation of gains from the alienation of property.

Paragraph 1 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.

Paragraph 2 provides that the rule of paragraph 1 applies to shares of the stock of any company that consists principally of real property situated in a Contracting State, and a participation in any partnership, trust or estate to the extent attributable to real property situated in a Contracting State. 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 section 897 of the Internal Revenue Code (or any successor statute). Thus, the United State preserves its right to collect the tax imposed by section 897 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 under section 861(a)(5) shall determine whether a real property interest is situated in the United States.

Paragraph 3 provides that gains from the alienation of personal property that are attributable to a permanent establishment that an enterprise of one of the States maintains in the other State may be taxed in the other State. The same rule applies to a fixed base used for the purpose of performing independent personal services, and to gain from the alienation of a permanent establishment or fixed base described in this paragraph. 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 in the other State to be taxed as gains attributable to such permanent establishment. 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 13.

Paragraph 4 provides that gains from the alienation of property other than that described in this Article shall be taxable only in the State of which the alienator is a resident. The rule in this paragraph is subject to the provisions of Article 8 (Shipping and Air Transport). Gains described in Article 8 are taxable in accordance with the provisions of that Article.

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). Articles 16 through 20 provide exceptions and additions to these general rules for directors' fees (Article 16); income of artistes and sportsmen (Article 17); government service salaries (Article 18); pensions in respect of personal service income and social security benefits (Article 19); and certain income of students, trainees and researchers (Article 20).

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 two 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)); and 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. If those two 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 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 "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.

As indicated in paragraph 4 of Article 6 (Income from Real Property), the provisions of Article 6 rather then of Article 14 will apply to income from real property that is used for the performance of independent personal services.

Paragraph 5 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 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 the other Contracting State if the conditions specified in paragraph 2 are satisfied.

Paragraph 1 also provides that the more specific rules of Articles 18 (Government Service), and 19 (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 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.

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 employer 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 through 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 a special rule that provides for exemption from tax at source for remuneration for services performed as an employee aboard a ship or aircraft operated in international traffic. Such income is taxable only in the State of the employee's residence.

Article 16. DIRECTORS' FEES

This Article provides that a Contracting State may tax the

director's fees and similar payments 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. For this purpose, "similar payments" 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 article is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope).

Article 17. ARTISTES AND SPORTSMEN

This Article deals with the taxation by one State of artistes (i.e., performing artists and entertainers) and sportsmen resident in the other State from the performance of their services as such. The Article applies both to the income of an entertainer or sportsman 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 14 (Independent Personal Services) and 15 (Dependent Personal Services). This Article applies, however, only with respect to the income of performing artists and sportsmen. 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 provides that income derived by a resident of one State from his personal activities as an entertainer or sportsmen exercised in the other State may be taxed in that other State. This provision corresponds to the OECD Model, but departs from most recent U.S. treaties in that the latter have introduced a dollar threshold test to distinguish between individuals who earn very high compensation in a short period of time, and modestly compensated individuals who are not clearly distinguishable from those who earn other types of personal service income. The potential inconsistency in treatment of modestly compensated artistes and sportsmen on the one hand and other categories of modestly compensated employees on the other is addressed in part, however, by paragraph 3 of this Article, which is discussed below.

Income derived from one State by an entertainer or sportsman 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 this Convention, such as Article 12 (Royalties).

Paragraph 2 is intended to eliminate the potential for abuse

when income from a performance by an entertainer or sportsman 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, a nominal employer may be a company established and owned by the performer, and merely act as the nominal recipient of the remuneration for the employee's performance. The entertainer may be acting as a nominal employee for a nominal salary, and arrange to receive the remainder of the income from the performance at a later time or in another form. 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.

Paragraph 2 prevents this type of abuse while protecting the taxpayer's rights to the benefits of the Convention when there is a legitimate employer-employee 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) participates, 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 imposed on the person providing the services of the entertainer or sportsman. This paragraph does not affect the rules of paragraph 1, which apply to the entertainer or sportsman 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 sportsman) if that person has control over, or the right to receive, gross income in respect of the services of the entertainer or sportsman. 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.

Paragraph 2 does not apply if it is established that neither the entertainer or sportsman, nor any persons related to him, participate directly or indirectly in the profits of the person providing the services of the entertainer or athlete.

Paragraph 3 provides an exception to the rules of paragraphs 1 and 2. It exempts income of a resident of one of the Contracting States from tax in the State in which the artiste or sportsman performs his activities if the visit to that State is substantially supported by public funds of the State in which the artiste or sportsman resides, or the visit is made pursuant to an arrangement agreed to by the Contracting States (such as a cultural exchange). Thus, for example, if an orchestra or ballet troupe that is substantially supported by public funds in one of the States were to visit the other Contracting State, its members would not be subject to tax in the other Contracting State on their income from performing in the other Contracting State.

This article is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope).

Article 18. GOVERNMENT SERVICE

This Article follows the corresponding provisions of the OECD Model.

Paragraph 1 provides that payments from the public funds of a Contracting State or political subdivision or local authority to compensate an individual for performing governmental services generally may be taxed only by that State. However, if the individual is either a citizen of the other State, or 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 the other (residence) State also may tax the pension (and must grant a foreign tax credit for any taxes paid to the paying State).

This rule does not apply to social security benefits and other public pensions that 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 19 (Pensions). 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 Ukrainian citizen and resident derives a pension for U.S. Government employment that is paid under the social security system, Ukraine

may tax that pension. This could happen, for example, if a locally hired driver for the U.S. Embassy in Kiev 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 Ukraine to its employees at the Ukrainian 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 Ukraine, 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.)

This article applies only to remuneration and pensions paid in respect of services of a governmental nature. Paragraph 3 provides that remuneration and pensions paid in respect of services for a government-conducted business (for example, a government-operated airline) are covered by Articles 14 (Independent Personal Services), 15 (Dependent Personal Services) or 19 (Pensions), as appropriate.

Article 19. PENSIONS

Except as provided in Article 18 (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 Ukraine 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.

Social security benefits and other public pensions paid by a Contracting State, other than in consideration of past employment, 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 Ukrainian 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, Ukraine, or a third country).

Since annuities, alimony and child support are not dealt with in this article or elsewhere in the Convention, they are taxable under Article 21 (Other Income). Under that Article

these items of income are taxable exclusively in the State of residence.

Article 20. 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 Ukrainian 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.

Unlike the 1973 Convention, the Convention does not provide any special benefits for teachers. Pursuant to Article 29 (Entry into Force), the benefits provided by the 1973 Convention may be claimed for the first taxable year after the entry into force of the Convention, but in that case none of the benefits of the new Convention may be claimed during that year.

Article 21. 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, and cancellation of indebtedness income.

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 7 (Business Profits) or 14 (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 Ukraine would be taxable by the United States.

Article 22. LIMITATION ON BENEFITS

Article 22 addresses the problem of "treaty shopping" by limiting source basis tax benefits granted by a Contracting State pursuant to the Convention to those residents of the other Contracting State that have a substantial business nexus with, or otherwise have a significant business purpose for residing in, 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. Article 22 limits the abuse of the Convention by limiting the benefits of the Convention to those persons whose residence in a Contracting State has not been motivated by the existence of the Convention. Absent Article 22, the entity would generally be entitled to benefits as a resident of a Contracting State, although the entity might be denied those benefits as a result of limitations imposed by the domestic law of the source State, (e.g., business purpose, substance-over-form, step transaction or conduit principles). Article 22 and the anti-abuse provisions of domestic law complement each other, as

Article 22 generally determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions determine whether a particular transaction should be recast in accordance with its substance.

Article 22 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 6 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 Ukrainian 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 subparagraphs (a), (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.

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 taxpayer 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 22.

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.

Article 23. PROPERTY

This Article specifies the circumstances in which a Contracting State may impose tax on property owned by a resident of the other Contracting State. Since neither the United States nor Ukraine 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 real property (as defined in Article 6 (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 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 (Shipping and Air 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 property.

Article 24. 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 7 of the Protocol explains and modifies this Article. Subparagraph (a) of paragraph 7 of the Protocol modifies the Ukrainian taxes described in Article 2 (Taxes Covered), i.e., the tax on income (profits) of enterprises, the income tax on individuals, and any substantially similar tax that

is subsequently introduced. The modified taxes constitute separate levies (i.e., are considered to be distinct from the Ukrainian 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 such levies conform to taxes on net income that would satisfy the U.S. standards of a creditable foreign income tax.

At the time the Convention was signed, the base on which the Ukrainian 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 Ukrainian participation (either wholly owned by Ukrainian residents or joint ventures with Ukrainian participation). The Protocol's modifications remove this obstacle to creditability of the Ukrainian tax for the persons described in the Protocol. Based on these modifications, the Protocol provides that the Ukrainian taxes described in Article 2, as modified by this Convention and in effect on the date of signature of the Convention (March 4, 1994), are income taxes for purposes of Article 24 (Relief from Double Taxation), and therefore are fully creditable for U.S. income tax purposes. This provision has no effect on the creditability of Ukrainian taxes imposed on persons other than those described in the Protocol; the creditability of taxes imposed on such persons would be determined under the general principles of U.S. law.

Subparagraph (a) of paragraph 7 of the Protocol permits full deductions for wages and interest expense of a joint venture that is a resident of Ukraine when U.S. residents own at least 20 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 U.S. venture may deduct its expenses for remuneration for personal services in determining its Ukrainian tax base. Subparagraph (a) also applies to a permanent establishment in Ukraine of a United States resident, and to an individual who is a U.S. citizen or resident and who carries on activities in Ukraine as an entrepreneur (i.e., a sole proprietorship or self-employed service provider). This provision does not alter the general rule under Article 7 (Business Profits) that deductions will not be allowed for interest paid by a permanent establishment to the home office. Consequently, in accordance with Article 7 (Business Profits), a permanent establishment will be allowed deductions for interest expenses only to the extent they are reasonably allocable to the permanent establishment.

Subparagraph (b) of paragraph 7 of the Protocol provides that the 20 percent beneficial U.S. ownership requirement of subparagraph 7(a) of the Protocol for eligible U.S. ventures may be satisfied by indirect ownership through residents of the

United States or Ukraine. Thus, for example, a Ukrainian company that is wholly-owned by another Ukrainian company would be an eligible U.S. venture if at least 20 percent of the second Ukrainian company were owned by a U.S. resident. If, however, the second Ukrainian company were a resident of a third state, the U.S. ownership of that second company would not be considered for purposes of subparagraph 7(a).

Subparagraph (c) ensures that the U.S. recipient of Ukrainian source dividends and royalties can claim a U.S. foreign tax credit with respect to the Ukrainian withholding taxes imposed on such income. Under Ukrainian law, the payor of dividends and royalties is considered to be liable for the withholding tax, rather than the recipient as under U.S. law. Subparagraph (c) provides that for U.S. tax purposes the recipient will be deemed to be liable for the tax, if the recipient elects to include the tax in gross income, thereby ensuring that the Ukrainian tax may be claimed as a credit against U.S. liability.

Finally, subparagraph (d) provides that no tax sparing credits will be provided. If the United States permits such a credit in the future, whether through an amendment of its internal law or through a treaty with a third State, it is agreed that the Convention will be amended to authorize the provision of such credits. Such an amendment to the Convention would be subject to constitutionally required ratification procedures in each State. The United States has undertaken a similar obligation with respect to the income tax convention with India.

25. 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.

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 burdensome 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 Ukraine 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 Ukraine or a third country, is not in the same circumstances as a citizen of Ukraine 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 Ukrainian citizen is subject to U.S. tax on only his U.S. income. Thus, a citizen of Ukraine 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 which is carrying on the same activities.

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 Ukrainian 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.

Paragraphs 3 and 4 prevent discrimination against residents of a Contracting State who engage in business transactions with residents of the other Contracting State. 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 6 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. 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. In this case, the Article would also apply to a real property tax imposed by a local government.

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 Ukrainian 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 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 Ukraine 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 the provisions of this Article do not extend to benefits granted to citizens or residents of a third State in accordance with a special agreement with that third State, such as an income tax Convention.

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. 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 Ukraine 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 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. 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 7 (Business Profits) and Article 9 (Associated Enterprises). 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, and differences in meanings of a term. 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 27. 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 Ukraine 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 Ukraine 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.

Paragraph 4 provides that this Article applies to taxes of every kind and description, irrespective of whether they are described in 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. This Article protects the fiscal privileges of technical staff and other employees of such missions as well as those with diplomatic status.

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 at Kiev.

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 July 10, 1994, the withholding rates on dividends, interest and royalties would be reduced (or eliminated) for amounts paid on or after August 1, 1995. 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.

Paragraph 4 provides that a person entitled to the benefits of the 1973 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, i.e., a taxpayer may not elect the 1973 Convention for one purpose and the Convention for another purpose.

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. 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 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.

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TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE PROTOCOL AMENDING THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND CANADA WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL SIGNED AT WASHINGTON ON SEPTEMBER 26, 1980, AS AMENDED BY THE PROTOCOLS SIGNED ON JUNE 14, 1983 AND MARCH 28, 1984

The Protocol, signed at Washington on March 17, 1995 (the "Protocol"), amends the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, signed at Washington on September 26, 1980, as amended by the Protocols signed on June 14, 1983 and March 28, 1984 (collectively referred to as the "Convention"). This technical explanation is an official guide to the Protocol. It explains policies behind particular provisions, as well as understandings reached during the negotiations 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. To the extent that the Convention has not been amended by the Protocol, the Technical Explanation of the Convention remains the official explanation. References to "he" or "his" should be read to mean "he" or "she" or "his" or "her."

Article 1

Article 1 of the Protocol amends Article II (Taxes Covered) of the Convention. Article II identifies the taxes to which the Convention applies. Paragraph 1 of Article 1 replaces paragraphs 2 through 4 of Article II of the Convention with new paragraphs 2 and 3. For each Contracting State, new paragraph 2 of Article II specifies the taxes existing on the date of signature of the Protocol to which the Convention applies. New paragraph 3 provides that the Convention will also apply to taxes identical or substantially similar to those specified in paragraph 2, and to any new capital taxes, that are imposed after the date of signature of the Protocol.

New paragraph 2(a) of Article II describes the Canadian taxes covered by the Convention. As amended by the Protocol, the Convention will apply to all taxes imposed by the Government of Canada under the Income Tax Act.

New paragraph 2(b) of Article II amends the provisions identifying the U.S. taxes covered by the Convention in several respects. The Protocol incorporates into paragraph 2(b) the special rules found in paragraph 4 of Article II of the present Convention. New paragraph 2(b)(iii) conforms the rule previously found in paragraph 4(c) of Article II to the amended provisions of Article XXIV (Elimination of Double Taxation), under which Canada has agreed to grant a foreign tax credit for U.S. social security taxes. In addition, the Protocol adds a fourth special rule to reflect the addition to the Convention of new Article XXIX B (Taxes Imposed by Reason of Death) and related provisions in new paragraph 3(g) of Article XXVI (Mutual Agreement Procedure).

Article 1 of the Protocol also makes minor clarifying, non-substantive amendments to paragraphs 2 and 3 of the Article.

Article 2

This Article of the Protocol amends paragraphs 1(c) and 1(d) of Article III (General Definitions) of the Convention. These paragraphs define the terms "Canadian tax" and "United States tax," respectively. The present Convention defines "Canadian tax" to mean the Canadian taxes specified in paragraph 2(a) or 3(a) of Article II (Taxes Covered), _i.e._, Canadian income taxes. It similarly defines the term "United States tax" to mean the U.S. taxes specified in paragraph 2(b) or 3(a) of Article II, _i.e._, U.S. income taxes.

As amended by the Protocol, paragraph 2(a) of Article II of the Convention covers all taxes imposed by Canada under its Income Tax Act, including certain taxes that are not income taxes. As explained below, paragraph 2(b) is similarly amended by the Protocol to include certain U.S. taxes that are not income taxes. It was, therefore, necessary to amend the terms "Canadian tax" and "United States tax" so that they would continue to refer exclusively to the income taxes imposed by each Contracting State. The amendment to the definition of the term "Canadian tax" ensures, for example, that the Protocol will not obligate the United States to give a foreign tax credit under Article XXIV (Elimination of Double Taxation) for covered taxes other than income taxes.

The definition of "United States tax," as amended, excludes certain United States taxes that are covered in Article II only for certain limited purposes under the Convention. These include the accumulated earnings tax, the personal holding company tax, foundation excise taxes, social security taxes, and estate taxes. To the extent that these are to be creditable taxes in Canada, that fact is specified elsewhere in the Convention. A Canadian income tax credit for U.S. social security taxes is provided in new paragraph 2(a)(ii) of Article XXIV (Elimination of Double Taxation). A Canadian income tax credit for the U.S. estate taxes is provided in paragraph 6 of new Article XXIX B (Taxes Imposed by Reason of Death).

Article 3

Article 3 of the Protocol amends Article IV (Residence) of the Convention. It clarifies the meaning of the term "resident" in certain cases and adds a special rule, found in a number of recent U.S. treaties, for determining the residence of U.S. citizens and "green-card" holders.

The first sentence of paragraph 1 of Article IV sets forth the general criteria for determining residence under the Convention. It is amended by the Protocol to state explicitly that a person will be considered a resident of a Contracting State for purposes of the Convention if he is liable to tax in that Contracting State by reason of citizenship. Although the sentence applies to both Contracting States, only the United States taxes its non-resident citizens in the same manner as its residents. Aliens admitted to the United States for permanent residence ("green card" holders) continue to qualify as U.S. residents under the first sentence of paragraph 1, because they are taxed by the United States as residents, regardless of where they physically reside.

U.S. citizens and green card holders who reside outside the United States, however, may have relatively little personal or economic nexus with the United States. The Protocol adds a

second sentence to paragraph 1 that acknowledges this fact by limiting the circumstances under which such persons are to be treated, for purposes of the Convention, as U.S. residents. Under that sentence, a U.S. citizen or green card holder will be treated as a resident of the United States for purposes of the Convention, and, thereby, be entitled to treaty benefits, only if (1) the individual has a substantial presence, permanent home, or habitual abode in the United States, and (2) the individual's personal and economic relations with the United States are closer than those with any third country. If, however, such an individual is a resident of both the United States and Canada under the first sentence of the paragraph, his residence for purposes of the Convention is determined instead under the "tie-breaker" rules of paragraph 2 of the Article.

The fact that a U.S. citizen who does not have close ties to the United States may not be treated as a U.S. resident under Article IV of the Convention does not alter the application of the saving clause of paragraph 2 of Article XXIX (Miscellaneous Rules) to that citizen. However, like any other individual that is a resident alien under U.S. law, a green card holder is treated as a resident of the United States for purposes of the saving clause only if he qualifies as such under Article IV.

New paragraph 1(a) confirms that the term "resident" of a Contracting State includes the Government of that State or a political subdivision or local authority of that State, as well as any agency or instrumentality of one of these governmental entities. This is implicit in the current Convention and in other U.S. and Canadian treaties, even where not specified.

New paragraph 1 also clarifies, in subparagraph (b), that trusts, organizations, or other arrangements operated exclusively to provide retirement or employee benefits, and other not-for-profit organizations, such as organizations described in section 501(c) of the Internal Revenue Code, are residents of a Contracting State if they are constituted in that State and are generally exempt from income taxation in that State by reason of their nature as described above. This change clarifies that the specified entities are to be treated as residents of one of the Contracting States. This corresponds to the interpretation that had previously been adopted by the Contracting States. Such entities, therefore, will be entitled to the benefits of the Convention with respect to the other Contracting State, provided that they satisfy the requirements of new Article XXIX A (Limitation on Benefits) (discussed below).

Article 3 of the Protocol adds a sentence to paragraph 3 of Article IV of the current Convention to address the residence of certain dual resident corporations. Certain jurisdictions allow local incorporation of an entity that is already organized and incorporated under the laws of another country. Under Canadian

law, such an entity is referred to as having been "continued" into the other country. Although the Protocol uses the Canadian term, the provision operates reciprocally. The new sentence states that such a corporation will be considered a resident of the State into which it is continued. Paragraph 5 of Article 21 of the Protocol governs the effective date of this provision.

Article 4

Article 4 of the Protocol amends paragraphs 3 and 4 of Article IX (Related Persons) of the Convention. Paragraph 1 of Article IX authorizes a Contracting State to adjust the amount of income, loss, or tax payable by a person with respect to arrangements between that person and a related person in the other Contracting State, when such arrangements differ from those that would obtain between unrelated persons. Under the present Convention, if an adjustment is made or to be made by a Contracting State under paragraph 1, paragraph 3 obligates the other Contracting State to make a corresponding adjustment if two conditions are satisfied: (1) the other Contracting State agrees with the adjustment made or to be made by the first Contracting State, and (2) the competent authority of the other Contracting State has received notice of the first adjustment within six years of the end of the taxable year to which that adjustment relates. If notice is not given within the six-year period, and if the person to whom the first adjustment relates is not notified of the adjustment at least six months prior to the end of the six-year period, paragraph 4 of Article IX of the present Convention requires that the first Contracting State withdraw its adjustment, to the extent necessary to avoid double taxation.

Article 4 of the Protocol amends paragraphs 3 and 4 of Article IX to prevent taxpayers from using the notification requirements of the present Convention to avoid adjustments. Paragraph 4, as amended, eliminates the requirement that a Contracting State withdraw an adjustment if the notification requirement of paragraph 3 has not been met. Paragraph 4 is also amended to delete the requirement that the taxpayer be notified at least six months before expiration of the six-year period specified in paragraph 3.

As amended by the Protocol, Article IX also explicitly authorizes the competent authorities to relieve double taxation in appropriate cases, even if the notification requirement is not satisfied. Paragraph 3 confirms that the competent authorities may agree to a corresponding adjustment if such an adjustment is not otherwise barred by time or procedural limitations such as the statute of limitations. Paragraph 4 provides that the competent authority of the State making the initial adjustment may grant unilateral relief from double taxation in other cases, although such relief is not obligatory.

Article 5

Article 5 of the Protocol amends Article X (Dividends) of the Convention. Paragraph 1 of Article 5 amends paragraph 2(a) of Article X to reduce from 10 percent to 5 percent the maximum rate of tax that may be imposed by a Contracting State on the gross amount of dividends beneficially owned by a company resident in the other Contracting State that owns at least 10 percent of the voting stock of the company paying the dividends. The rate at which the branch profits tax may be imposed under paragraph 6 is also reduced by paragraph 1 of Article 5 from 10 percent to 5 percent. Under the entry-into-force provisions of Article 21 of the Protocol, these reductions will be phased in over a three-year period.

Paragraph 2 of Article 5 of the Protocol replaces paragraph 7 of Article X of the Convention with a new paragraph 7. Paragraph 7 of the existing Convention is no longer relevant because it applies only in the case where a Contracting State does not impose a branch profits tax. Both Contracting States now do impose such a tax.

New paragraph 7 makes the 5 percent withholding rate of new paragraph 2(a) inapplicable in certain situations. Under new paragraph 7(b), dividends paid by U.S. regulated investment companies (RICs) are denied the 5 percent withholding rate even if the Canadian shareholder is a corporation that would otherwise qualify as a direct investor by satisfying the 10-percent ownership requirement. Consequently, all RIC dividends to Canadian beneficial owners are subjected to the 15 percent rate that applies to dividends paid to portfolio investors.

Dividends paid by U.S. real estate investment trusts (REITs) to Canadian beneficial owners are also denied the 5 percent rate under the rules of paragraph 7(c). REIT dividends paid to individuals who own less than a 10 percent interest in the REIT are subject to withholding at a maximum rate of 15 percent. Paragraph 7(c) also provides that dividend distributions by a REIT to an estate or a testamentary trust acquiring the interest in the REIT as a consequence of the death of an individual will be treated as distributions to an individual, for the five-year period following the death. Thus, dividends paid to an estate or testamentary trust in respect of a holding of less than a 10 percent interest in the REIT also will be entitled to the 15 percent rate of withholding, but only for up to five years after the death. REIT dividends paid to other Canadian beneficial owners are subject to the rate of withholding tax that applies under the domestic law of the United States (i.e., 30 percent).

The denial of the 5 percent withholding rate at source to all RIC and REIT shareholders, and the denial of the 15 percent rate to most shareholders of REITs, is intended to prevent the

use of these non-taxable conduit entities to gain unjustifiable benefits for certain shareholders. For example, a Canadian corporation that wishes to hold a 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 Canadian corporation owns more than 10 percent of the shares, but in which there are enough 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 Canadian corporation of interposing the RIC as an intermediary in the chain of ownership. It is unlikely that a 10 percent shareholding in a RIC will constitute a 10 percent shareholding in any company from which the dividends originate. In the absence of the special rules in paragraph 7(b), however, interposition of a RIC would transform what should be portfolio dividends into direct investment dividends taxable at source by the United States only at 5 percent. The special rules of paragraph 7 prevent this.

Similarly, a resident of Canada may hold U.S. real property directly and pay U.S. tax either at a 30 percent rate on the gross income or at the income tax rates specified in the Internal Revenue Code on the net income. By placing the real estate holding in a REIT, the Canadian investor could transform real estate income into dividend income and thus transform high-taxed income into much lower-taxed income. In the absence of the special rule, if the REIT shareholder were a Canadian corporation that owned 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 rate of 30 percent or more would be significantly reduced. The exception is the relatively small individual Canadian investor who might be subject to U.S. tax at a rate of only 15 percent on the net income even if he earned the real estate income directly. Under the rule in paragraph 7(c), such individuals, defined as those holding less than a 10 percent interest in the REIT, remain taxable at source at a 15 percent rate.

Subparagraph (a) of paragraph 7 provides a special rule for certain dividends paid by Canadian non-resident-owned investment corporations ("NROs"). The subparagraph provides for a maximum rate of 10 percent (instead of the standard rate of 5 percent) for dividends paid by NROs that are Canadian residents to a U.S. company that owns 10 percent or more of the voting stock of the NRO and that is the beneficial owner of the dividend. This rule maintains the rate available under the current Convention for dividends from NROs. Canada wanted the withholding rate for direct investment NRO dividends to be no lower than the maximum withholding rates under the Convention on interest and royalties, to make sure that a foreign investor cannot transform interest or royalty income subject to a 10 percent withholding tax into

direct dividends qualifying for a 5 percent withholding tax by passing it through to an NRO.

Article 6

Article 6 of the Protocol amends Article XI (Interest) of the Convention. Paragraph 1 of the Article reduces the general maximum withholding rate on interest under paragraph 2 of Article XI from 15 percent to 10 percent.

Paragraph 3 of Article XI of the Convention provides that, notwithstanding the general withholding rate applicable to interest payments under paragraph 2, certain specified categories of interest are exempt from withholding at source. Paragraph 2 of Article 6 of the Protocol amends paragraph 3(d) of the Convention, which deals with interest paid on indebtedness arising in connection with a sale on credit of equipment, merchandise, or services. The exemption provided by that paragraph in the Convention is broadened under the Protocol to apply to interest that is beneficially owned either by the seller in the underlying transaction, as under the present Convention, or by any beneficial owner of interest paid with respect to an indebtedness arising as a result of the sale on credit of equipment, merchandise, or services. This exemption, however, does not apply in cases where the purchaser is related to the seller or the debtor is related to the beneficial owner of the interest. The negotiators agreed that this exemption is subject, as are the other provisions of the Convention, to any anti-avoidance rules applicable under the respective domestic law of the Contracting States.

The reference to "related persons" in paragraph 3(d) of Article XI of the Convention, as amended, is a change from the present Convention, which refers to "persons dealing at arm's length." The term "related person" as used in this Article is not defined for purposes of the Convention. Accordingly, the meaning of the term, and, therefore, the application of this Article, will be governed by the domestic law of each Contracting State (as is true with the use of the term "arm's-length" under the current Convention) under the interpretative rule of paragraph 2 of Article III (General Definitions). The United States will define the term "related person" as under section 482 of the Internal Revenue Code, to include organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests. The Canadian definition of "related persons" is found in section 251 of the Income Tax Act.

Paragraph 3 of Article 6 of the Protocol adds a new paragraph 9 to Article XI of the Convention. Although the definition of "interest" in paragraph 4 includes an excess inclu-

sion with respect to a residual interest in a real estate mortgage investment conduit (REMIC) described in section 860G of the Internal Revenue Code, new paragraph 9 provides that the reduced rates of tax at source for interest provided for in paragraphs 2 and 3 do not apply to such income. This class of interest, therefore, remains 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. The 30 percent rate of tax on excess inclusions received by residents of Canada is consistent with this expression of Congressional intent.

Article 7

Article 7 of the Protocol modifies Article XII (Royalties) of the Convention by expanding the classes of royalties exempt from withholding of tax at source. Paragraph 3, as amended by the Protocol, identifies four classes of royalty payments arising in one Contracting State and beneficially owned by a resident of the other that are exempt at source: (1) subparagraph (a) preserves the exemption in paragraph 3 of the present Convention for copyright royalties in respect of literary and other works, other than certain such payments in respect of motion pictures, videotapes, and similar payments; (2) subparagraph (b) specifies that computer software royalties are also exempt; (3) subparagraph (c) adds royalties paid for the use of, or the right to use, patents and information concerning industrial, commercial, and scientific experience, other than payments in connection with rental or franchise agreements; and (4) subparagraph (d) allows the Contracting States to reach an agreement, through an exchange of diplomatic notes, with respect to the application of paragraph 3 of Article XII to payments in respect of certain live broadcasting transmissions.

The specific reference to software in subparagraph (b) is not intended to suggest that the United States views the term "copyright" as excluding software in other U.S. treaties (including the current treaty with Canada).

The negotiators agreed that royalties paid for the use of, or the right to use, designs or models, plans, secret formulas, or processes are included under subparagraph 3(c) to the extent that they represent payments for the use of, or the right to use, information concerning industrial, commercial, or scientific experience. In addition, they agreed that royalties paid for the use of, or the right to use, "know-how," as defined in paragraph 11 of the Commentary on Article 12 of the OECD Model Income Tax Treaty, constitute payments for the use of, or the right to use, information concerning industrial, commercial, or scientific experience. The negotiators further agreed that a royalty paid under a "mixed contract," "package fee," or similar arrangement

will be treated as exempt at source by virtue of paragraph 3 to the extent of any portion that is paid for the use of, or the right to use, property or information with respect to which paragraph 3 grants an exemption.

The exemption granted under subparagraph 3(c) does not, however, extend to payments made for information concerning industrial, commercial, or scientific experience that is provided in connection with a rental or franchise agreement. For this purpose, the negotiators agreed that a franchise is to be distinguished from other arrangements resulting in the transfer of intangible property. They agreed that a license to use intangibles (whether or not including a trademark) in a territory, in and of itself, would not constitute a franchise agreement for purposes of subparagraph 3(c) in the absence of other rights and obligations in the license agreement or in any other agreement that would indicate that the arrangement in its totality constituted a franchise agreement. For example, a resident of one Contracting State may acquire a right to use a secret formula to manufacture a particular product (e.g., a perfume), together with the right to use a trademark for that product and to market it at a non-retail level, in the other Contracting State. Such an arrangement would not constitute a franchise in the absence of any other rights or obligations under that arrangement or any other agreement that would indicate that the arrangement in its totality constituted a franchise agreement. Therefore, the royalty payment under that arrangement would be exempt from withholding tax in the other Contracting State to the extent made for the use of, or the right to use, the secret formula or other information concerning industrial, commercial, or scientific experience; however, it would be subject to withholding tax at a rate of 10 percent, to the extent made for the use of, or the right to use, the trademark.

The provisions of paragraph 3 do not fully reflect the U.S. treaty policy of exempting all types of royalty payments from taxation at source, but Canada was not prepared to grant a complete exemption for all types of royalties in the Protocol. Although the Protocol makes several important changes to the royalty provisions of the present Convention in the direction of bringing Article XII into conformity with U.S. policy, the United States remains concerned about the imposition of withholding tax on some classes of royalties and about the associated administrative burdens. In this connection, the Contracting States have affirmed their intention to collaborate to resolve in good faith any administrative issues that may arise in applying the provisions of subparagraph 3(c). The United States intends to continue to pursue a zero rate of withholding for all royalties in future negotiations with Canada, including discussions under Article 20 of the Protocol, as well as in negotiations with other countries.

As noted above, new subparagraph 3(d) enables the Contracting States to provide an exemption for royalties paid with respect to broadcasting through an exchange of notes. This provision was included because Canada was not prepared at the time of the negotiations to commit to an exemption for broadcasting royalties. Subparagraph 3(d) was included to enable the Senate to give its advice and consent in advance to such an exemption, in the hope that such an exemption could be obtained without awaiting the negotiation of another full protocol. Any agreement reached under the exchange of notes authorized by subparagraph 3(d) would lower the withholding rate from 10 percent to zero and, thus, bring the Convention into greater conformity with established U.S. treaty policy.

Paragraph 2 of Article 7 of the Protocol amends the rules in paragraph 6 of Article XII of the Convention for determining the source of royalty payments. Under the present Convention, royalties generally are deemed to arise in a Contracting State if paid by a resident of that State. However, if the obligation to pay the royalties was incurred in connection with a permanent establishment or a fixed base in one of the Contracting States that bears the expense, the royalties are deemed to arise in that State.

The Protocol continues to apply these basic rules but changes the scope of an exception provided under the present Convention. Under the present Convention, a royalty paid for the use of, or the right to use, property in a Contracting State is deemed to arise in that State. Under the Protocol, this "place of use" exception applies only if the Convention does not otherwise deem the royalties to arise in one of the Contracting States. Thus, the "place of use" exception will apply only if royalties are neither paid by a resident of one of the Contracting States nor borne by a permanent establishment or fixed base in either State. For example, if a Canadian resident were to grant franchise rights to a resident of Chile for use in the United States, the royalty paid by the Chilean resident to the Canadian resident for those rights would be U.S. source income under this Article, subject to U.S. withholding at the 10 percent rate provided in paragraph 2.

The rules of this Article differ from those provided under U.S. domestic law. Under U.S. domestic law, a royalty is considered to be from U.S. sources if it is paid for the use of, or the privilege of using, an intangible within the United States; the residence of the payor is irrelevant. If paid to a nonresident alien individual or other foreign person, a U.S. source royalty is generally subject to withholding tax at a rate of 30 percent under U.S. domestic law. By reason of paragraph 1 of Article XXIX (Miscellaneous Rules), a Canadian resident would be permitted to apply the rules of U.S. domestic law to its royalty income if those rules produced a more favorable result in

its case than those of this Article. However, under a basic principle of tax treaty interpretation recognized by both Contracting States, the prohibition against so-called "cherry-picking," the Canadian resident would be precluded from claiming selected benefits under the Convention (e.g., the tax rates only) and other benefits under U.S. domestic law (e.g., the source rules only) with respect to its royalties. See, e.g., Rev. Rul. 84-17, 1984-1 C.B. 308. For example, if a Canadian company granted franchise rights to a resident of the United States for use 50 percent in the United States and 50 percent in Chile, the Convention would permit the Canadian company to treat all of its royalty income from that single transaction as U.S. source income entitled to the withholding tax reduction under paragraph 2. U.S. domestic law would permit the Canadian company to treat 50 percent of its royalty income as U.S. source income subject to a 30 percent withholding tax and the other 50 percent as foreign source income exempt from U.S. tax. The Canadian company could choose to apply either the provisions of U.S. domestic law or the provisions of the Convention to the transaction, but would not be permitted to claim both the U.S. domestic law exemption for 50 percent of the income and the Convention's reduced withholding rate for the remainder of the income.

Royalties generally are considered borne by a permanent establishment or fixed base if they are deductible in computing the taxable income of that permanent establishment or fixed base.

Since the definition of "resident" of a Contracting State in Article IV (Residence), as amended by Article 3 of the Protocol, specifies that this term includes the Contracting States and their political subdivisions and local authorities, the source rule does not include a specific reference to these governmental entities.

Article 8

Article 8 of the Protocol broadens the scope of paragraph 8 of Article XIII (Gains) of the Convention to cover organizations, reorganizations, amalgamations, and similar transactions involving either corporations or other entities. The present Convention covers only transactions involving corporations. The amendment is intended to make the paragraph applicable to transactions involving other types of entities, such as trusts and partnerships.

As in the case of transactions covered by the present Convention, the deferral allowed under this provision shall be for such time and under such other conditions as are stipulated between the person acquiring the property and the competent authority. The agreement of the competent authority of the State of source is entirely discretionary and, when granted, will be granted only to the extent necessary to avoid double taxation.

Article 9

Article 9 of the Protocol amends Article XVIII (Pensions and Annuities) of the Convention. Paragraph 3 of Article XVIII defines the term "pensions" for purposes of the Convention, including the rules for the taxation of cross-border pensions in paragraphs 1 and 2 of the Article, the rules in paragraphs 2 and 3 of Article XXI (Exempt Organizations) for certain income derived by pension funds, and the rules in paragraph 1(b)(i) of Article IV (Residence) regarding the residence of pension funds and certain other entities. The Protocol amends the present definition by substituting the phrase "other retirement arrangement" for the phrase "retirement plan." The purpose of this change is to clarify that the definition of "pensions" includes, for example, payments from Individual Retirement Accounts (IRAs) in the United States and to provide that "pensions" inlcudes, for example, Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) in Canada. The term "pensions" also would include amounts paid by other retirement plans or arrangements, whether or not they are qualified plans under U.S. domestic law; this would include, for example, plans and arrangements described in section 457 or 414(d) of the Internal Revenue Code.

Paragraph 2 of Article 9 of the Protocol amends paragraph 5 of Article XVIII to modify the treatment of social security benefits under the Convention. Under the amended paragraph, benefits paid under the U.S. or Canadian social security legislation to a resident of the other Contracting State, or, in the case of Canadian benefits, to a U.S. citizen, are taxable exclusively in the paying State. This amendment brings the Convention into line with current U.S. treaty policy. Social security benefits are defined, for this purpose, to include tier 1 railroad retirement benefits but not unemployment benefits (which therefore fall under Article XXII (Other Income) of the Convention). Pensions in respect of government service are covered not by this rule but by the rules of paragraphs 1 and 2 of Article XVIII.

The special rule regarding U.S. citizens is intended to clarify that only Canada, and not the United States, may tax a social security payment by Canada to a U.S. citizen not resident in the United States. This is consistent with the intention of the general rule, which is to give each Contracting State exclusive taxing jurisdiction over its social security payments. Since paragraph 5 is an exception to the saving clause, Canada will retain exclusive taxing jurisdiction over Canadian social security benefits paid to U.S. residents and citizens, and vice versa. It was not necessary to provide a special rule to clarify the taxation of U.S. social security payments to Canadian citizens, because Canada does not tax on the basis of citizenship

and, therefore, does not include citizens within the scope of its saving clause.

A new paragraph 7 is added to Article XVIII by Article 9 of the Protocol. This paragraph replaces paragraph 5 of Article XXIX (Miscellaneous Rules) of the present Convention. The new paragraph makes reciprocal the rule that it replaced and expands its scope, so that it no longer applies only to residents and citizens of the United States who are beneficiaries of Canadian RRSPs. As amended, paragraph 7 applies to an individual who is a citizen or resident of a Contracting State and a beneficiary of a trust, company, organization, or other arrangement that is a resident of the other Contracting State and that is both generally exempt from income taxation in its State of residence and operated exclusively to provide pension, retirement, or employee benefits. Under this rule, the beneficiary may elect to defer taxation in his State of residence on income accrued in the plan until it is distributed or rolled over into another plan. The new rule also broadens the types of arrangements covered by this paragraph in a manner consistent with other pension-related provisions of the Protocol.

Article 10

Article 10 of the Protocol amends Article XXI (Exempt Organizations) of the Convention. Paragraph 1 of Article 10 amends paragraphs 2 and 3 of Article XXI. The most significant changes are those that conform the language of the two paragraphs to the revised definition of the term "pension" in paragraph 3 of Article XVIII (Pensions and Annuities). The revision adds the term "arrangement" to "trust, company or organization" in describing the residents of a Contracting State that may receive dividend and interest income exempt from current income taxation by the other Contracting State. This clarifies that IRAs, for example, are eligible for the benefits of paragraph 2, subject to the exception in paragraph 3, and makes Canadian RRSPs and RRIFs, for example, similarly eligible (provided that they are operated exclusively to administer or provide pension, retirement, or employee benefits).

The other changes, all in paragraph 2, are intended to improve and clarify the language. For example, the reference to "tax" in the present Convention is changed to a reference to "income taxation." This is intended to clarify that if an otherwise exempt organization is subject to an excise tax, for example, it will not lose the benefits of this paragraph. In subparagraph 2(b), the phrase "not taxed in a taxable year" was changed to "generally exempt from income taxation in a taxable year" to ensure uniformity throughout the Convention; this change was not intended to disqualify a trust or other arrangement that qualifies for the exemption under the wording of the present Convention.

Paragraph 2 of Article 10 adds a sentence to paragraph 5 of Article XXI of the Convention. The paragraph in the present Convention provides that a U.S. citizen or resident may deduct, for U.S. income tax purposes, contributions made to Canadian charities under certain circumstances. The added sentence makes clear that the benefits of the paragraph are available to a company that is a resident of Canada but is treated by the United States as a domestic corporation under the consolidated return rules of section 1504(d) of the Internal Revenue Code. Thus, such a company will be able to deduct, for U.S. income tax purposes, contributions to Canadian charities that are deductible to a U.S. resident under the provisions of the paragraph.

Paragraph 3 of Article 10 amends paragraph 6 of Article XXI of the Convention to replace references to "deductions" for Canadian tax purposes with references to "relief" from tax. These changes clarify that the provisions of paragraph 6 apply to the credit for charitable contributions allowed under current Canadian law. The Protocol also makes other non-substantive drafting changes to paragraph 6.

Article 11

Article 11 of the Protocol adds a new paragraph 3 to Article XXII (Other Income) of the Convention. This Article entitles residents of one Contracting State who are taxable by the other State on gains from wagering transactions to deduct losses from wagering transactions for the purposes of taxation in that other State. However, losses are to be deductible only to the extent that they are incurred with respect to wagering transactions, the gains on which could be taxable in the other State, and only to the extent that such losses would be deductible if incurred by a resident of that other State.

This Article does not affect the collection of tax by a Contracting State. Thus, in the case of a resident of Canada, this Article does not affect, for example, the imposition of U.S. withholding taxes under section 1441 or section 1442 of the Internal Revenue Code on the gross amount of gains from wagering transactions. However, in computing its U.S. income tax liability on net income for the taxable year concerned, the Canadian resident may reduce its gains from wagering transactions subject to taxation in the United States by any wagering losses incurred on such transactions, to the extent that those losses are deductible under the provisions of new paragraph 3. Under U.S. domestic law, the deduction of wagering losses is governed by section 165 of the Internal Revenue Code. It is intended that the resident of Canada file a nonresident income tax return in order to substantiate the deduction for losses and to claim a refund of any overpayment of U.S. taxes collected by withholding.

Article 12

Article 12 of the Protocol amends Article XXIV (Elimination of Double Taxation) of the Convention. Paragraph 1 of Article 12 amends the rules for Canadian double taxation relief in subparagraphs (a) and (b) of paragraph 2 of Article XXIV. The amendment to subparagraph (a) obligates Canada to give a foreign tax credit for U.S. social security taxes paid by individuals. The amendment to subparagraph (b) of paragraph 2 does not alter the substantive effect of the rule, but conforms the language to current Canadian law. Under the provision as amended, Canada generally continues to allow an exemption to a Canadian corporation for direct dividends paid from the exempt surplus of a U.S. affiliate.

Paragraphs 4 and 5 of Article XXIV of the Convention provide double taxation relief rules, for both the United States and Canada, with respect to U.S. source income derived by a U.S. citizen who is resident in Canada. These rules address the fact that a U.S. citizen resident in Canada remains subject to U.S. tax on his worldwide income at ordinary progressive rates, and may, therefore, be subject to U.S. tax at a higher rate than a resident of Canada who is not a U.S. citizen. In essence, these paragraphs limit the foreign tax credit that Canada is obliged to allow such a U.S. citizen to the amount of tax on his U.S. source income that the United States would be allowed to collect from a Canadian resident who is not a U.S. citizen. They also oblige the United States to allow the U.S. citizen a credit for any income tax paid to Canada on the remainder of his income. Paragraph 4 deals with items of income other than dividends, interest, and royalties and is not changed by the Protocol. Paragraph 5, which deals with dividends, interest, and royalties, is amended by paragraph 2 of Article 12 of the Protocol.

The amendments to paragraph 5 of the Article make that paragraph applicable only to dividend, interest, and royalty income that would be subject to a positive rate of U.S. tax if paid to a Canadian resident who is not a U.S. citizen. This means that the rules of paragraph 4, not paragraph 5, will apply to items of interest and royalties, such as portfolio interest, that would be exempt from U.S. tax if paid to a non-U.S. citizen resident in Canada. Under paragraph 4, Canada will not allow a credit for the U.S. tax on such income, and the United States will credit the Canadian tax to the extent necessary to avoid double taxation.

Paragraph 2 of Article 12 of the Protocol makes further technical amendments to paragraph 5 of Article XXIV of the Convention. The existing Technical Explanation of paragraphs 5 and 6 of Article XXIV of the Convention should be read as follows to reflect the amendments made by the Protocol:

Paragraph 5 provides special rules for the elimination of double taxation in the case of dividends, interest, and royalties earned by a U.S. citizen resident in Canada. These rules apply notwithstanding the provisions of paragraph 4, but only as long as the law in Canada allows a deduction in computing income for the portion of any foreign tax paid in respect of dividends, interest, or royalties which exceeds 15 percent of the amount of such items of income, and only with respect to those items of income. The rules of paragraph 4 apply with respect to other items of income; moreover, if the law in force in Canada regarding the deduction for foreign taxes is changed so as to no longer allow such a deduction, the provisions of paragraph 5 shall not apply and the U.S. foreign tax credit for Canadian taxes and the Canadian credit for U.S. taxes will be determined solely pursuant to the provisions of paragraph 4.

The calculations under paragraph 5 are as follows. First, the deduction allowed in Canada in computing income shall be made with respect to U.S. tax on the dividends, interest, and royalties before any foreign tax credit by the United States with respect to income tax paid or accrued to Canada. Second, Canada shall allow a deduction from (credit against) Canadian tax for U.S. tax paid or accrued with respect to the dividends, interest, and royalties, but such credit need not exceed the amount of income tax that would be paid or accrued to the United States on such items of income if the individual were not a U.S. citizen after taking into account any relief available under the Convention. Third, for purposes of computing the U.S. tax on such dividends, interest, and royalties, the United States shall allow as a credit against the U.S. tax the income tax paid or accrued to Canada after the credit against Canadian tax for income tax paid or accrued to the United States. The United States is in no event obliged to give a credit for Canadian income tax which will reduce the U.S. tax below the amount of income tax that would be paid or accrued to the United States on the amount of the dividends, interest, and royalties if the individual were not a U.S. citizen after taking into account any relief available under the Convention.

The rules of paragraph 5 are illustrated by the following examples.

Example B

-- A U.S. citizen who is a resident of Canada has $100 of dividend income arising in the United States. The tentative U.S. tax before foreign tax credit is $40.

-- Canada, under its law, allows a deduction for the U.S. tax in excess of 15 percent or, in this case, a deduction of $25 ($40 - $15). The Canadian taxable income is $75 and the Canadian tax on that amount is $35.

-- Canada gives a credit of $15 (the maximum credit allowed is 15 percent of the gross dividend taken into Canadian income) and collects a net tax of $20.

-- The United States allows a credit for the net Canadian tax against its tax in excess of 15 percent. Thus, the maximum credit is $25 ($40 - $15). But since the net Canadian tax paid was $20, the usable credit is $20.

-- To be able to use a credit of $20 requires Canadian source taxable income of $50 (50% of the U.S. tentative tax of $40). Under paragraph 6, $50 of the U.S. dividend is resourced to be of Canadian source. The credit of $20 may then be offset against the U.S. tax of $40, leaving a net U.S. tax of $20.

-- The combined tax paid to both countries is $40, $20 to Canada and $20 to the United States.

Example C

A U.S. citizen who is a resident of Canada receives $200 of income with respect to personal services performed within Canada and $100 of dividend income arising within the United States. Taxable income for U.S. purposes, taking into account the rules of Code section 911, is $220. U.S. tax (before foreign tax credits) is $92. The $100 of dividend income is deemed to bear U.S. tax (before foreign tax credits) of $41.82 ($100/$200 x $92). Under Canadian law, a deduction of $26.82 (the excess of $41.82 over 15 percent of the $100 dividend income) is allowed in computing income. The Canadian tax on $273.18 of income ($300 less the $26.82 deduction) is $130. Canada then gives a credit against the $130 for $15 (the U.S. tax paid or accrued with respect to the dividend, $41.82 but limited to 15 percent of the gross amount of such income, or $15), leaving a final Canadian tax of $115. Of the $115, $30.80 is attributable to the dividend:

<u>$73.18 ($100 dividend less $26.82 deduction)</u> x $115
$273.18 ($300 income less $26.82 deduction)

Of this amount, $26.82 is creditable against U.S. tax pursuant to paragraph 5. (Although the U.S. allows a credit for the Canadian tax imposed on the dividend, $30.80, the credit may not reduce the U.S. tax below 15 percent of the amount of the dividend. Thus, the maximum allowable credit

is the excess of $41.82, the U.S. tax imposed on the dividend income, over $15, which is 15 percent of the $100 dividend). The remaining $3.98 (the Canadian tax of $30.80 less the credit allowed of $26.82) is a foreign tax credit carryover for U.S. purposes, subject to the limitations of paragraph 5. (An additional $50.18 of Canadian tax with respect to Canadian source services income is creditable against U.S. tax pursuant to paragraphs 3 and 4(b). The $50.18 is computed as follows: tentative U.S. tax (before foreign tax credits) is $92; the U.S. tax on Canadian source services income is $50.18 ($92 less the U.S. tax on the dividend income of $41.82); the limitation on the services income is:

<u>$120 (taxable income from services)</u> x $92
$220 (total taxable income),

or $50.18. The credit for Canadian tax paid on the services income is therefore $50.18; the remainder of the Canadian tax on the services income, or $34.02, is a foreign tax credit carryover for U.S. purposes, subject to the limitations of paragraph 5.)

Paragraph 6 is necessary to implement the objectives of paragraphs 4(b) and 5(c). Paragraph 6 provides that where a U.S. citizen is a resident of Canada, items of income referred to in paragraph 4 or 5 are deemed for the purposes of Article XXIV to arise in Canada to the extent necessary to avoid double taxation of income by Canada and the United States consistent with the objectives of paragraphs 4(b) and 5(c). Paragraph 6 can override the source rules of paragraph 3 to permit a limited resourcing of income. The principles of paragraph 3 have effect, pursuant to paragraph 3(b) of Article XXX (Entry Into Force) of the Convention, for taxable years beginning on or after January 1, 1976. See the discussion of Article XXX below.

The application of paragraph 6 is illustrated by the following example.

Example D

The facts are the same as in Example C. The United States has undertaken, pursuant to paragraph 5(c) and paragraph 6, to credit $26.82 of Canadian taxes on dividend income that has a U.S. source under both paragraph 3 and the Internal Revenue Code. (As illustrated in Example C, the credit, however, only reduces the U.S. tax on the dividend income which exceeds the amount of income tax that would be paid or accrued to the United States on such income if the individual were not a U.S. citizen after taking into account any relief available under the Convention. Pursuant to

paragraph 6, for purposes of determining the U.S. foreign tax credit limitation under the Convention with respect to Canadian taxes,

$$\$64.13 \quad \left(\frac{A}{\$220} \times \$92 = \$26.82;\ A = \$64.13 \right)$$

of taxable income with respect to the dividends is deemed to arise in Canada.

Paragraph 3 of Article 12 of the Protocol makes a technical amendment to paragraph 7 of Article XXIV. It conforms the reference to U.S. and Canadian taxes to the amended definitions of "United States tax" and "Canadian tax" in subparagraphs (c) and (d) of paragraph 1 of Article III (General Definitions). No substantive change in the effect of the paragraph is intended.

Paragraph 4 of Article 12 of the Protocol adds a new paragraph 10 to Article XXIV of the Convention. This paragraph provides for the application of the rule of "exemption with progression" by a Contracting State in cases where an item of income of a resident of that State is exempt from tax in that State by virtue of a provision of the Convention. For example, where under Canadian law a tax benefit, such as the goods and services tax credit, to a Canadian resident individual is reduced as the income of that individual, or the individual's spouse or other dependent, increases, and any of these persons receives U.S. social security benefits that are exempt from tax in Canada under the Convention, Canada may, nevertheless, take the U.S. social security benefits into account in determining whether, and to what extent, the benefit should be reduced.

New Article XXIX B (Taxes Imposed by Reason of Death), added by Article 19 of the Protocol, also provides relief from double taxation in certain circumstances in connection with Canadian income tax imposed by reason of death and U.S. estate taxes. However, subparagraph 7(c) of Article XXIX B generally denies relief from U.S. estate tax under that Article to the extent that a credit or deduction has been claimed for the same amount in determining any other tax imposed by the United States. This restriction would operate to deny relief, for example, to the extent that relief from U.S. income tax is claimed under Article XXIV in respect of the same amount of Canadian tax. There is, however, no requirement that relief from U.S. tax be claimed first (or exclusively) under Article XXIV. Paragraph 6 of Article XXIX B also prevents the claiming of double relief from Canadian income taxation under both that Article and Article XXIV, by providing that the credit provided by Article XXIX B applies only after the application of the credit provided by Article XXIV.

Article 13

Article 13 of the Protocol amends Article XXV (Non-Discrimination) of the Convention. Paragraph 1 of Article 13 amends paragraph 3 of Article XXV to conform the treaty language to a change in Canadian law. The paragraph is intended to allow the treatment of dependents under the income tax law of a Contracting State to apply with respect to dependents who are residents of the other Contracting State. As drafted in the present Convention, the rule deals specifically only with deductions; the amendments made by the Protocol clarify that it also applies to the credits now provided by Canadian law.

Paragraph 2 of Article 13 of the Protocol amends paragraph 10 of Article XXV of the Convention to broaden the scope of the non-discrimination protection provided by the Convention. As amended, Article XXV will apply to all taxes imposed by a Contracting State. Under the present Convention, non-discrimination protection is limited in the case of Canadian taxes to taxes imposed under the Income Tax Act. As amended by the Protocol, non-discrimination protection will extend, for example, to the Canadian goods and services tax and other Canadian excise taxes.

Article 14

Article 14 of the Protocol makes two changes to Article XXVI (Mutual Agreement Procedure) of the Convention. First, it adds a new subparagraph 3(g) specifically authorizing the competent authorities to provide relief from double taxation in certain cases involving the distribution or disposition of property by a U.S. qualified domestic trust or a Canadian spousal trust, where relief is not otherwise available.

Article 14 also adds a new paragraph 6 to Article XXVI (Mutual Agreement Procedure). Paragraph 6 provides for a voluntary arbitration procedure, to be implemented only upon the exchange of diplomatic notes between the United States and Canada. Similar provisions are found in the recent U.S. treaties with the Federal Republic of Germany, the Netherlands, and Mexico. Paragraph 6 provides that where the competent authorities have been unable, pursuant to the other provisions of Article XXVI, to resolve a disagreement regarding the interpretation or application of the Convention, the disagreement may, with the consent of the taxpayer and both 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. However, if a case is submitted to an arbitration board, the board's decision in that case will be binding on both Contracting States and on the taxpayer with respect to that case.

The United States was reluctant to implement an arbitration procedure until there has been an opportunity to evaluate the process in practice under other agreements that allow for arbitration, particularly the U.S.-Germany Convention. It was agreed, therefore, as specified in paragraph 6, that the provisions of the Convention calling for an arbitration procedure will not take effect until the two Contracting States have agreed through an exchange of diplomatic notes to do so. This is similar to the approach taken with the Netherlands and Mexico. Paragraph 6 also provides that the procedures to be followed in applying arbitration will be agreed through an exchange of notes by the Contracting States. It is expected that such procedures will ensure that arbitration will not generally be available where matters of either State's tax policy or domestic law are involved.

Paragraph 2 of Article 20 of the Protocol provides that the appropriate authorities of the Contracting State will consult after three years following entry into force of the Protocol to determine whether the diplomatic notes implementing the arbitration procedure should be exchanged.

Article 15

Article 15 of the Protocol adds to the Convention a new Article XXVI A (Assistance in Collection). Collection assistance provisions are included in several other U.S. income tax treaties, including the recent treaty with the Netherlands, and in many U.S. estate tax treaties. U.S. negotiators initially raised with Canada the possibility of including collection assistance provisions in the Protocol, because the Internal Revenue Service has claims pending against persons in Canada that would be subject to collection under these provisions. However, the ultimate decision of the U.S. and Canadian negotiators to add the collection assistance article was attributable to the confluence of several unusual factors.

Of critical importance was the similarity between the laws of the United States and Canada. The Internal Revenue Service, the Justice Department, and other U.S. negotiators were reassured by the close similarity of the legal and procedural protections afforded by the Contracting States to their citizens and residents and by the fact that these protections apply to the tax collection procedures used by each State. In addition, the U.S. negotiators were confident, given their extensive experience in working with their Canadian counterparts, that the agreed procedures could be administered appropriately, effectively, and efficiently. Finally, given the close cooperation already developed between the United States and Canada in the exchange of tax information, the U.S. and Canadian negotiators concluded that the potential benefits to both countries of obtaining such assistance

would be immediate and substantial and would far outweigh any cost involved.

Under paragraph 1 of Article XXVI A, each Contracting State agrees, subject to the exercise of its discretion and to the conditions explicitly provided later in the Article, to lend assistance and support to the other in the collection of revenue claims. The term "revenue claim" is defined in paragraph 1 to include all taxes referred to in paragraph 9 of the Article, as well as interest, costs, additions to such taxes, and civil penalties. Paragraph 9 provides that, notwithstanding the provisions of Article II (Taxes Covered) of the Convention, Article XXVI A shall apply to all categories of taxes collected by or on behalf of the Government of a Contracting State.

Paragraph 2 of the Article requires the Contracting State applying for collection assistance (the "applicant State") to certify that the revenue claim for which collection assistance is sought has been "finally determined." A revenue claim has been 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.

Paragraph 3 of the Article clarifies that the Contracting State from which assistance was requested (the "requested State") has discretion as to whether to accept a particular application for collection assistance. However, if the application for assistance is accepted, paragraph 3 requires that the requested State grant assistance under its existing procedures as though the claim were the requested State's own revenue claim finally determined under the laws of that State. This obligation under paragraph 3 is limited by paragraph 7 of the Article, which provides that, although generally treated as a revenue claim of the requested State, a claim for which collection assistance is granted shall not have any priority accorded to the revenue claims of the requested State.

Paragraph 4 of Article XXVI A provides that, when the United States accepts a request for assistance in collection, the claim will be treated by the United States as an assessment as of the time the application was received. Similarly, when Canada accepts a request, a revenue claim shall be treated as an amount payable under the Income Tax Act, the collection of which is not subject to any restriction.

Paragraph 5 of the Article provides that nothing in Article XXVI A shall be construed as creating in the requested State any rights of administrative or judicial review of the applicant State's finally determined revenue claim. Thus, when an application for collection assistance has been accepted, the substantive validity of the applicant State's revenue claim cannot be chal-

lenged in an action in the requested State. Paragraph 5 furthers provides, however, that if the applicant State's revenue claim ceases to be finally determined, the applicant State is obligated to withdraw promptly any request that had been based on that claim.

Paragraph 6 provides that, as a general rule, the requested State is to forward the entire amount collected to the competent authority of the applicant State. The ordinary costs incurred in providing collection assistance will normally be borne by the requested State and only extraordinary costs will be borne by the applicant State. The application of this paragraph, including rules specifying which collection costs are to be borne by each State and the time and manner of payment of the amounts collected, will be agreed upon by the competent authorities, as provided for in paragraph 11.

Paragraph 8 provides that no assistance is to be given under this Article for a claim in respect of an individual taxpayer, to the extent that the taxpayer can demonstrate that he was a citizen of the requested State during the taxable period to which the revenue claim relates. Similarly, in the case of a company, estate, or trust, no assistance is to be given to the extent that the entity can demonstrate that it derived its status as such under the laws in force in the requested State during the taxable period to which the claim relates.

Subparagraph (a) of paragraph 10 clarifies that Article XXVI A supplements the provisions of paragraph 4 of Article XXVI (Mutual Agreement Procedure). The Mutual Agreement Procedure paragraph, which is more common in U.S. tax treaties, provides for collection assistance in cases in which a Contracting State seeks assistance in reclaiming treaty benefits that have been granted to a person that is not entitled to those benefits. Subparagraph (b) of paragraph 10 makes clear that nothing in Article XXVI A can require a Contracting State to carry out administrative measures of a different nature from those used in the collection of its own taxes, or that would be contrary to its public policy (ordre public).

Paragraph 11 requires the competent authorities to agree upon the mode of application of Article XXVI A, including agreement to ensure comparable levels of assistance to each of the Contracting States.

Paragraph 3 of Article 21 of the Protocol allows collection assistance under Article XXVI A to be sought for revenue claims that have been finally determined at any time within the 10 years preceding the date on which the Protocol enters into force.

Article 16

Article 16 of the Protocol amends Article XXVII (Exchange of Information) of the Convention. Paragraph 1 of Article 16 amends paragraph 1 of Article XXVII. The first change is a wording change to make it clear that information must be exchanged if it is "relevant" for carrying out the provisions of the Convention or of the domestic laws of the Contracting States, even if it is not "necessary." Neither the United States nor Canada views this as a substantive change. The second amendment merely conforms the language of the paragraph to the language of Article II (Taxes Covered), as amended, by referring to the taxes "to which the Convention applies" rather than to the taxes "covered by the Convention."

The Protocol further amends paragraph 1 to allow a Contracting State to provide information received from the other Contracting State to its states, provinces, or local authorities, if it relates to a tax imposed by that state, province, or local authority that is substantially similar to a national-level tax covered under Article II (Taxes Covered). However, this provision does not authorize a Contracting State to request information on behalf of a state, province, or local authority. The Protocol also amends paragraph 1 to authorize the competent authorities to release information to any arbitration panel that may be established under the provisions of new paragraph 6 of Article XXVI (Mutual Agreement Procedure). Any information provided to a state, province, or local authority or to an arbitration panel is subject to the same use and disclosure provisions as is information received by the national Governments and used for their purposes.

Paragraph 2 of Article 16 amends paragraph 4 of Article XXVII, which describes the applicable taxes for the purposes of this Article. Under the present Convention, the Article applies in Canada to taxes imposed by the Government of Canada under the Income Tax Act and on estates and gifts and in the United States to all taxes imposed under the Internal Revenue Code. The Protocol broadens the scope of the Article to apply to "all taxes imposed by a Contracting State." This change allows information to be exchanged, for example, with respect to Canadian excise taxes, as is the case with respect to U.S. excise taxes under the present Convention. Paragraph 4 is also amended to authorize the exchange of information with respect to other taxes, to the extent relevant to any other provision of the Convention.

Article 17

Article 17 of the Protocol amends Article XXIX (Miscellaneous Rules) of the Convention. Paragraph 1 of Article 17 modifies paragraph 3(a), the exceptions to the saving clause, to conform the cross-references in the paragraph to changes in other

parts of the Convention. The paragraph also adds to the exceptions to the saving clause certain provisions of Article XXIX B (Taxes Imposed by Reason of Death). Thus, certain benefits under that Article will be granted by a Contracting State to its residents and, in the case of the United States, to its citizens, notwithstanding the saving clause of paragraph 2 of Article XXIX.

Paragraph 2 of Article 17 replaces paragraphs 5 through 7 of Article XXIX of the present Convention with three new paragraphs. (Paragraph 5 in the present Convention was moved to paragraph 7 of Article XVIII (Pensions and Annuities), and paragraphs 6 and 7 were deleted as unnecessary.) New paragraph 5 provides a rule for the taxation by Canada of a Canadian resident that is a shareholder in a U.S. S corporation. The application of this rule is relatively limited, because U.S. domestic law requires that S corporation shareholders be either U.S. citizens or U.S. residents. Therefore, the rule provided by paragraph 5 would apply only to an S corporation shareholder who is a resident of both the United States and Canada (i.e., a "dual resident" who meets certain requirements), determined before application of the "tie-breaker" rules of Article IV (Residence), or a U.S. citizen resident in Canada. Since the shareholder would be subject to U.S. tax on its share of the income of the S corporation as it is earned by the S corporation and, under Canadian statutory law, would be subject to tax only when the income is distributed, there could be a timing mismatch resulting in unrelieved double taxation. Under paragraph 5, the shareholder can make a request to the Canadian competent authority for relief under the special rules of the paragraph. Under these rules, the Canadian shareholder will be subject to Canadian tax on essentially the same basis as he is subject to U.S. tax, thus eliminating the timing mismatch.

The Protocol adds to Article XXIX a new paragraph 6, which provides a coordination rule for the Convention and the General Agreement on Trade in Services ("GATS"). Paragraph 6(a) provides that, for purposes of paragraph 3 of Article XXII (Consultation) of the GATS, a measure falls within the scope of the Convention only if the measure relates to a tax (1) to which Article XXV (Non-Discrimination) of the Convention applies, or (2) to which Article XXV does not apply and to which any other provision of the Convention applies, but only to the extent that the measure relates to a matter dealt with in that other provision. Under paragraph 6(b), notwithstanding paragraph 3 of Article XXII of the GATS, any doubt as to the interpretation of subparagraph (a) will be resolved under paragraph 3 of Article XXVI (Mutual Agreement Procedure) of the Convention or any other procedure agreed to by both Contracting States.

GATS generally obliges its Members to provide national treatment and most-favored-nation treatment to services and service suppliers of other Members. A very broad exception from

the national treatment obligation applies to direct taxes. An exception from the most-favored-nation obligation applies to a difference in treatment resulting from an international agreement on the avoidance of double taxation (a "tax agreement") or from provisions on the avoidance of double taxation in any other international agreement or arrangement by which the Member is bound.

Article XXII(3) of GATS specifically provides that there will be no access to GATS procedures to settle a national treatment dispute concerning a measure that falls within the scope of a tax agreement. This provision preserves the exclusive application of nondiscrimination obligations in the tax agreement and clarifies that the competent authority mechanism provided by the tax agreement will apply, instead of GATS procedures, to resolve nondiscrimination disputes involving the taxation of services and service suppliers.

In the event of a disagreement between Members as to whether a measure falls within the scope of a tax agreement that existed at the time of the entry into force of the Agreement establishing the World Trade Organization, Article XXII(2), footnote 11, of GATS reserves the resolution of the dispute to the Contracting States under the tax agreement. In such a case, the issue of the scope of a tax agreement may be resolved under GATS procedures (rather than tax treaty procedures) only if both parties to the existing tax agreement consent. With respect to subsequent tax agreements, GATS provides that either Member may bring the jurisdictional matter before the Council for Trade In Services, which will refer the matter to arbitration for a decision that will be final and binding on the Members.

Both Canada and the United States agree that a protocol to a convention that is grandfathered under Article XXII(2), footnote 11, of GATS is also grandfathered. Nevertheless, since the Protocol extends the application of the Convention, and particularly the nondiscrimination article, to additional taxes (e.g., some non-income taxes imposed by Canada), the negotiators sought to remove any ambiguity and agreed to a provision that clarified the scope of the Convention and the relationship between the Convention and GATS.

The purpose of new paragraph 6(a) of the Convention is to provide the agreement of the Contracting States as to the measures considered to fall within the scope of the Convention in applying Article XXII(3) of GATS between the Contracting States. The purpose of new paragraph 6(b) is to reserve the resolution of the issue of the scope of the Convention for purposes of Article XXII(3) of GATS to the competent authorities under the Convention rather than to settlement under GATS procedures.

The Protocol also adds to Article XXIX a new paragraph 7, relating to certain changes in the law or treaty policy of either of the Contracting States. Paragraph 7 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. If a change in domestic legislation has unilaterally removed or significantly limited a material benefit provided by the Convention, the appropriate authorities are instructed by the paragraph to consult promptly to consider an appropriate amendment to the Convention. The "appropriate authorities" may be the Contracting States themselves or the competent authorities under the Convention. The consultations may be initiated by the authority of the Contracting State making the change in law or policy or by the authority of the other State. Any change in the Convention recommended as a result of this process can be implemented only through the negotiation, signature, ratification, and entry into force of a new protocol to the Convention.

Article 18

In general.

Article 18 of the Protocol adds a new Article XXIX A (Limitation on Benefits) to the Convention. Article XXIX A addresses the problem of "treaty shopping" by requiring, in most cases, that the person seeking U.S. treaty benefits not only be a Canadian resident but also satisfy other tests. In a typical case of treaty shopping, a resident of a third State might establish an entity resident in Canada for the purpose of deriving income from the United States and claiming U.S. treaty benefits with respect to that income. Article XXIX A limits the benefits granted by the United States under the Convention to those persons whose residence in Canada is not considered to have been motivated by the existence of the Convention. Absent Article XXIX A, the entity would be entitled to U.S. benefits under the Convention as a resident of Canada, unless it were denied benefits as a result of limitations (e.g., business purpose, substance-over-form, step transaction, or conduit principles or other anti-avoidance rules) applicable to a particular transaction or arrangement. General anti-abuse provisions of this sort apply in conjunction with the Convention in both the United States and Canada. In the case of the United States, such anti-abuse provisions complement the explicit anti-treaty-shopping rules of Article XXIX A. While the anti-treaty-shopping rules determine whether a person has a sufficient nexus to Canada to be entitled to treaty benefits, general anti-abuse provisions determine whether a particular transaction should be recast in accordance with the substance of the transaction.

The present Convention deals with treaty-shopping in a very limited manner, in paragraph 6 of Article XXIX, by denying benefits to Canadian residents that benefit from specified provisions of Canadian law. The Protocol removes that paragraph 6 from Article XXIX, because it is superseded by the more general provisions of Article XXIX A.

The Article is not reciprocal, except for paragraph 7. Canada prefers to rely on general anti-avoidance rules to counter arrangements involving treaty-shopping through the United States.

The structure of the Article is as follows: Paragraph 1 states that, in determining whether a resident of Canada is entitled to U.S. benefits under the Convention, a "qualifying person" is entitled to all of the benefits of the Convention, and other persons are not entitled to benefits, except where paragraphs 3, 4, or 6 provide otherwise. Paragraph 2 lists a number of characteristics, any one of which will make a Canadian resident a qualifying person. These are essentially mechanical tests. Paragraph 3 provides an alternative rule, under which a Canadian resident that is not a qualifying person under paragraph 2 may claim U.S. benefits with respect to those items of U.S. source income that are connected with the active conduct of a trade or business in Canada. Paragraph 4 provides a limited "derivative benefits" test for entitlement to benefits with respect to U.S. source dividends, interest, and royalties beneficially owned by a resident of Canada that is not a qualifying person. Paragraph 5 defines certain terms used in the Article. Paragraph 6 requires the U.S. competent authority to grant benefits to a resident of Canada that does not qualify for benefits under any other provision of the Article, where the competent authority determines, on the basis of all factors, that benefits should be granted. Paragraph 7 clarifies the application of general anti-abuse provisions.

Individuals and governmental entities.

Under paragraph 2, the first two categories of qualifying persons are (1) individual residents of Canada, and (2) the Government of Canada, a political subdivision or local authority thereof, or an agency or instrumentality of that Government, political subdivision, or local authority. It is considered unlikely that persons falling into these two categories can be used, as the beneficial owner of income, to derive treaty benefits on behalf of a third-country person. If a person 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 of the income be a resident of a Contracting State.

Publicly traded entities.

Under subparagraph (c) of paragraph 2, a Canadian resident company or trust is a qualifying person if there is substantial and regular trading in the company's principal class of shares, or in the trust's units, on a recognized stock exchange. The term "recognized stock exchange" is defined in paragraph 5(a) of the Article to mean, in the United States, the NASDAQ System and any stock exchange registered as a national securities exchange with the Securities and Exchange Commission, and, in Canada, any Canadian stock exchanges that are "prescribed stock exchanges" under the Income Tax Act. These are, at the time of signature of the Protocol, the Alberta, Montreal, Toronto, Vancouver, and Winnipeg Stock Exchanges. Additional exchanges may be added to the list of recognized exchanges by exchange of notes between the Contracting States or by agreement between the competent authorities.

Certain companies owned by publicly traded corporations also may be qualifying persons. Under subparagraph (d) of paragraph 2, a Canadian resident company will be a qualifying person, even if not publicly traded, if more than 50 percent of the vote and value of its shares is owned (directly or indirectly) by five or fewer persons that would be qualifying persons under subparagraph (c). In addition, each company in the chain of ownership must be a qualifying person or a U.S. citizen or resident. Thus, for example, a Canadian company that is not publicly traded but that is owned, one-third each, by three companies, two of which are Canadian resident corporations whose principal classes of shares are substantially and regularly traded on a recognized stock exchange, will qualify under subparagraph (d).

The 50-percent test under subparagraph (d) applies only to shares other than "debt substitute shares." The term "debt substitute shares" is defined in paragraph 5 to mean shares defined in paragraph (e) of the definition in the Canadian Income Tax Act of "term preferred shares" (see section 248(1) of the Income Tax Act), which relates to certain shares received in debt-restructuring arrangements undertaken by reason of financial difficulty or insolvency. Paragraph 5 also provides that the competent authorities may agree to treat other types of shares as debt substitute shares.

Ownership/base erosion test.

Subparagraph (e) of paragraph 2 provides a two-part test under which certain other entities may be qualifying persons, based on ownership and "base erosion." Under the first of these tests, benefits will be granted to a Canadian resident company if 50 percent or more of the vote and value of its shares (other than debt substitute shares), or to a Canadian resident trust if 50 percent or more of its beneficial interest, is not owned,

directly or indirectly, by persons other than qualifying persons or U.S. residents or citizens. The wording of these tests is intended to make clear that, for example, if a Canadian company is more than 50 percent owned by a U.S. resident corporation that is, itself, wholly owned by a third-country resident other than a U.S. citizen, the Canadian company would not pass the ownership test. This is because more than 50 percent of its shares is owned indirectly by a person (the third-country resident) that is not a qualifying person or a citizen or resident of the United States.

For purposes of this subparagraph (e) and other provisions of this Article, the term "shares" includes, in the case of a mutual insurance company, any certificate or contract entitling the holder to voting power in the corporation. This is consistent with the interpretation of similar limitation on benefits provisions in other U.S. treaties.

The second test of subparagraph (e) is the so-called "base erosion" test. A Canadian company or trust that passes the ownership test must also pass this test to be a qualifying person. This test requires that the amount of expenses that are paid or payable by the Canadian entity in question to persons that are not qualifying persons or U.S. citizens or residents, and that are deductible from gross income, be less than 50 percent of the gross income of the company or trust. This test is applied for the fiscal period immediately preceding the period for which the qualifying person test is being applied. If it is the first fiscal period of the person, the test is applied for the current period.

The ownership/base erosion test recognizes that the benefits of the Convention can be enjoyed indirectly not only by equity holders of an entity, but also by that entity's obligees, such as lenders, licensors, service providers, insurers and reinsurers, and others. For example, a third-country resident could license technology to a Canadian-owned Canadian corporation to be sub-licensed to a U.S. resident. The U.S. source royalty income of the Canadian corporation would be exempt from U.S. withholding tax under Article XII (Royalties) of the Convention (as amended by the Protocol). While the Canadian corporation would be subject to Canadian corporation income tax, its taxable income could be reduced to near zero as a result of the deductible royalties paid to the third-country resident. If, under a Convention between Canada and the third country, those royalties were either exempt from Canadian tax or subject to tax at a low rate, the U.S. treaty benefit with respect to the U.S. source royalty income would have flowed to the third-country resident at little or no tax cost, with no reciprocal benefit to the United States from the third country. The ownership/base erosion test therefore requires both that qualifying persons or U.S. residents

or citizens substantially own the entity and that the entity's deductible payments be made in substantial part to such persons.

Other qualifying persons.

Under subparagraph (f) of paragraph 2, a Canadian resident estate is a qualifying person, entitled to the benefits of the Convention with respect to its U.S. source income.

Subparagraphs (g) and (h) specify the circumstances under which certain types of not-for-profit organizations will be qualifying persons. Subparagraph (g) of paragraph 2 provides that a not-for-profit organization that is a resident of Canada is a qualifying person, and thus entitled to U.S. benefits, if more than half of the beneficiaries, members, or participants in the organization are qualifying persons or citizens or residents of the United States. The term "not-for-profit organization" of a Contracting State is defined in subparagraph (b) of paragraph 5 of the Article to mean an entity created or established in that State that is generally exempt from income taxation in that State by reason of its not-for-profit status. The term includes charities, private foundations, trade unions, trade associations, and similar organizations.

Subparagraph (h) of paragraph 2 specifies that certain organizations described in paragraph 2 of Article XXI (Exempt Organizations), as amended by Article 10 of the Protocol, are qualifying persons. To be a qualifying person, such an organization must be established primarily for the purpose of providing pension, retirement, or employee benefits to individual residents of Canada who are (or were, within any of the five preceding years) qualifying persons, or to citizens or residents of the United States. An organization will be considered to be established "primarily" for this purpose if more than 50 percent of its beneficiaries, members, or participants are such persons. Thus, for example, a Canadian Registered Retirement Savings Plan ("RRSP") of a former resident of Canada who is working temporarily outside of Canada would continue to be a qualifying person during the period of the individual's absence from Canada or for five years, whichever is shorter. A Canadian pension fund established to provide benefits to persons employed by a company would be a qualifying person only if most of the beneficiaries of the fund are (or were within the five preceding years) individual residents of Canada or residents or citizens of the United States.

The provisions of paragraph 2 are self-executing, unlike the provisions of paragraph 6, discussed below. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

Active trade or business test.

Paragraph 3 provides an eligibility test for benefits for residents of Canada that are not qualifying persons under paragraph 2. This is the so-called "active trade or business" test. Unlike the tests of paragraph 2, the active trade or business test looks not solely at the characteristics of the person deriving the income, but also at the nature of the activity engaged in by that person and the connection between the income and that activity. Under the active trade or business test, a resident of Canada deriving an item of income from the United States is entitled to benefits with respect to that income if that person (or a person related to that person under the principles of Internal Revenue Code section 482) is engaged in an active trade or business in Canada and the income in question is derived in connection with, or is incidental to, that trade or business.

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 those investment activities are carried on with customers in the ordinary course of the business of a bank, insurance company, registered securities dealer, or deposit-taking financial institution.

Income is considered derived "in connection" with an active trade or business in the United States if, for example, the income-generating activity in the United States is "upstream," "downstream," or parallel to that conducted in Canada. Thus, if the U.S. activity consisted of selling the output of a Canadian manufacturer or providing inputs to the manufacturing process, or of manufacturing or selling in the United States the same sorts of products that were being sold by the Canadian trade or business in Canada, the income generated by that activity would be treated as earned in connection with the Canadian trade or business. Income is considered "incidental" to the Canadian trade or business if, for example, it arises from the short-term investment of working capital of the Canadian resident in U.S. securities.

An item of income will be considered to be earned in connection with or to be incidental to an active trade or business in Canada if the income is derived by the resident of Canada claiming the benefits directly or indirectly through one or more other persons that are residents of the United States. Thus, for example, a Canadian resident could claim benefits with respect to an item of income earned by a U.S. operating subsidiary but derived by the Canadian resident indirectly through a wholly-owned U.S. holding company interposed between it and the operating subsidiary. This language would also permit a Canadian resident to derive income from the United States through one or more U.S. residents that it does not wholly own. For example, a

Canadian partnership in which three unrelated Canadian companies each hold a one-third interest could form a wholly-owned U.S. holding company with a U.S. operating subsidiary. The "directly or indirectly" language would allow otherwise available treaty benefits to be claimed with respect to income derived by the three Canadian partners through the U.S. holding company, even if the partners were not considered to be related to the U.S. holding company under the principles of Internal Revenue Code section 482.

Income that is derived in connection with, or is incidental to, an active trade or business in Canada, must pass an additional test to qualify for U.S. treaty benefits. The trade or business in Canada must be substantial in relation to the activity in the United States that gave rise to the income in respect of which treaty benefits are being claimed. To be considered substantial, it is not necessary that the Canadian trade or business be as large as the U.S. income-generating activity. The Canadian trade or business cannot, however, in terms of income, assets, or other similar measures, represent only a very small percentage of the size of the U.S. activity.

The substantiality requirement is intended to prevent treaty-shopping. For example, a third-country resident may want to acquire a U.S. company that manufactures television sets for worldwide markets; however, since its country of residence has no tax treaty with the United States, any dividends generated by the investment would be subject to a U.S. withholding tax of 30 percent. Absent a substantiality test, the investor could establish a Canadian corporation that would operate a small outlet in Canada to sell a few of the television sets manufactured by the U.S. company and earn a very small amount of income. That Canadian corporation could then acquire the U.S. manufacturer with capital provided by the third-country resident and produce a very large number of sets for sale in several countries, generating a much larger amount of income. It might attempt to argue that the U.S. source income is generated from business activities in the United States related to the television sales activity of the Canadian parent and that the dividend income should be subject to U.S. tax at the 5 percent rate provided by Article X of the Convention, as amended by the Protocol. However, the substantiality test would not be met in this example, so the dividends would remain subject to withholding in the United States at a rate of 30 percent.

In general, it is expected that if a person qualifies for benefits under one of the tests of paragraph 2, no inquiry will be made into qualification for benefits under paragraph 3. Upon satisfaction of any of the tests of paragraph 2, any income derived by the beneficial owner from the other Contracting State is entitled to treaty benefits. Under paragraph 3, however, the test is applied separately to each item of income.

Derivative benefits test.

Paragraph 4 of Article XXIX A contains a so-called "derivative benefits" rule not generally found in U.S. treaties. This rule was included in the Protocol because of the special economic relationship between the United States and Canada and the close coordination between the tax administrations of the two countries.

Under the derivative benefits rule, a Canadian resident company may receive the benefits of Articles X (Dividends), XI (Interest), and XII (Royalties), even if the company is not a qualifying person and does not satisfy the active trade or business test of paragraph 3. To qualify under this paragraph, the Canadian company must satisfy both (i) the base erosion test under subparagraph (e) of paragraph 2, and (ii) an ownership test.

The derivative benefits ownership test requires that shares (other than debt substitute shares) representing more than 90 percent of the vote and value of the Canadian company be owned directly or indirectly by either (i) qualifying persons or U.S. citizens or residents, or (ii) other persons that satisfy each of three tests. The three tests that must be satisfied by these other persons are as follows:

First, the person must be a resident of a third State with which the United States has a comprehensive income tax convention and be entitled to all of the benefits under that convention. Thus, if the person fails to satisfy the limitation on benefits tests, if any, of that convention, no benefits would be granted under this paragraph. Qualification for benefits under an active trade or business test does not suffice for these purposes, because that test grants benefits only for certain items of income, not for all purposes of the convention.

Second, the person must be a person that would qualify for benefits with respect to the item of income for which benefits are sought under one or more of the tests of paragraph 2 or 3 of this Convention, if the person were a resident of Canada and, for purposes of paragraph 3, the business were carried on in Canada. For example, a person resident in a third country would be deemed to be a person that would qualify under the publicly-traded test of paragraph 2 of this Convention if the principal class of its shares were substantially and regularly traded on a stock exchange recognized either under the treaty between the United States and Canada or under the treaty between the United States and the third country. Similarly, a company resident in a third country would be deemed to satisfy the ownership/base erosion test of paragraph 2 under this hypothetical analysis if, for example, it were wholly owned by an individual resident in that third country and most of its deductible payments were made to

individual residents of that country (i.e., it satisfied base erosion).

The third requirement is that the rate of U.S. withholding tax on the item of income in respect of which benefits are sought must be at least as low under the convention between the person's country of residence and the United States as under this Convention.

Competent authority discretion.

Paragraph 6 provides that when a resident of Canada derives income from the United States and is not entitled to the benefits of the Convention under other provisions of the Article, benefits may, nevertheless be granted at the discretion of the U.S. competent authority. In making a determination under this paragraph, the competent authority will take into account all relevant facts and circumstances relating to the person requesting the benefits. In particular, the competent authority will consider the history, structure, ownership (including ultimate beneficial ownership), and operations of the person. In addition, the competent authority is to consider (1) whether the creation and existence of the person did not have as a principal purpose obtaining treaty benefits that would not otherwise be available to the person, and (2) whether it would not be appropriate, in view of the purpose of the Article, to deny benefits. The paragraph specifies that if the U.S. competent authority determines that either of these two standards is satisfied, benefits shall be granted.

For purposes of implementing paragraph 6, a taxpayer will be expected to present his case to the competent authority for an advance determination based on the facts. The taxpayer will not be required to wait until it has been determined that benefits are denied under one of the other provisions of the Article. It also is expected that, if and when 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 (assuming that the taxpayer also qualifies under the relevant facts for the earlier period).

General anti-abuse provisions.

Paragraph 7 was added at Canada's request to confirm that the specific provisions of Article XXIX A and the fact that these provisions apply only for the purposes of the application of the Convention by the United States should not be construed so as to limit the right of each Contracting State to invoke applicable anti-abuse rules. Thus, for example, Canada remains free to apply such rules to counter abusive arrangements involving "treaty-shopping" through the United States, and the United

States remains free to apply its substance-over-form and anti-conduit rules, for example, in relation to Canadian residents. This principle is recognized by the Organization for Economic Cooperation and Development in the Commentaries to its Model Tax Convention on Income and on Capital, and the United States and Canada agree that it is inherent in the Convention. The agreement to state this principle explicitly in the Protocol is not intended to suggest that the principle is not also inherent in other tax conventions, including the current Convention with Canada.

Article 19

In general.

Article 19 of the Protocol adds to the Convention a new Article XXIX B (Taxes Imposed by Reason of Death). The purpose of Article XXIX B is to better coordinate the operation of the death tax regimes of the two Contracting States. Such coordination is necessary because the United States imposes an estate tax, while Canada now applies an income tax on gains deemed realized at death rather than an estate tax. Article XXIX B also contains other provisions designed to alleviate death taxes in certain situations.

For purposes of new Article XXIX B, the term "resident" has the meaning provided by Article IV (Residence) of the Convention, as amended by Article 3 of the Protocol. The meaning of the term "resident" for purposes of Article XXIX B, therefore, differs in some respects from its meaning under the estate, gift, and generation-skipping transfer tax provisions of the Internal Revenue Code.

Charitable bequests.

Paragraph 1 of new Article XXIX B facilitates certain charitable bequests. It provides that a Contracting State shall accord the same death tax treatment to a bequest by an individual resident in one of the Contracting States to a qualifying exempt organization resident in the other Contracting State as it would have accorded if the organization had been a resident of the first Contracting State. The organizations covered by this provision are those referred to in paragraph 1 of Article XXI (Exempt Organizations) of the Convention. A bequest by a U.S. citizen or U.S. resident (as defined for estate tax purposes under the Internal Revenue Code) to such an exempt organization generally is deductible for U.S. estate tax purposes under section 2055 of the Internal Revenue Code, without regard to whether the organization is a U.S. corporation. However, if the decedent is not a U.S. citizen or U.S. resident (as defined for estate tax purposes under the Internal Revenue Code), such a bequest is deductible for U.S. estate tax purposes, under section

2106(a)(2) of the Internal Revenue Code, only if the recipient organization is a U.S. corporation. Under paragraph 1 of Article XXIX B, a U.S. estate tax deduction also will be allowed for a bequest by a Canadian resident (as defined under Article IV (Residence)) to a qualifying exempt organization that is a Canadian corporation. However, paragraph 1 does not allow a deduction for U.S. estate tax purposes with respect to any transfer of property that is not subject to U.S. estate tax.

Unified credit.

Paragraph 2 of Article XXIX B grants a "pro rata" unified credit to the estate of a Canadian resident decedent, for purposes of computing U.S. estate tax. Although the Congress anticipated the negotiation of such pro rata unified credits in Internal Revenue Code section 2102(c)(3)(A), this is the first convention in which the United States has agreed to give such a credit. However, certain exemption provisions of existing estate and gift tax conventions have been interpreted as providing a pro rata unified credit.

Under the Internal Revenue Code, the estate of a nonresident not a citizen of the United States is subject to U.S. estate tax only on its U.S. situs assets and is entitled to a unified credit of $13,000, while the estate of a U.S. citizen or U.S. resident is subject to U.S. estate tax on its entire worldwide assets and is entitled to a unified credit of $192,800. (For purposes of these Internal Revenue Code provisions, the term "resident" has the meaning provided for estate tax purposes under the Internal Revenue Code.) A lower unified credit is provided for the former category of estates because it is assumed that the estate of a nonresident not a citizen generally will hold fewer U.S. situs assets, as a percentage of the estate's total assets, and thus will have a lower U.S. estate tax liability. The pro rata unified credit provisions of paragraph 2 increase the credit allowed to the estate of a Canadian resident decedent to an amount between $13,000 and $192,800 in appropriate cases, to take into account the extent to which the assets of the estate are situated in the United States. Paragraph 2 provides that the amount of the unified credit allowed to the estate of a Canadian resident decedent will in no event be less than the $13,000 allowed under the Internal Revenue Code to the estate of a nonresident not a citizen of the United States (subject to the adjustment for prior gift tax unified credits, discussed below). Paragraph 2 does not apply to the estates of U.S. citizen decedents, whether resident in Canada or elsewhere, because such estates receive a unified credit of $192,800 under the Internal Revenue Code.

Subject to the adjustment for gift tax unified credits, the pro rata credit allowed under paragraph 2 is determined by multiplying $192,800 by a fraction, the numerator of which is the

value of the part of the gross estate situated in the United States and the denominator of which is the value of the entire gross estate wherever situated. Thus, if half of the entire gross estate (by value) of a decedent who was a resident and citizen of Canada were situated in the United States, the estate would be entitled to a pro rata unified credit of $96,400 (provided that the U.S. estate tax due is not less than that amount). For purposes of the denominator, the entire gross estate wherever situated (i.e., the worldwide estate, determined under U.S. domestic law) is to be taken into account for purposes of the computation. For purposes of the numerator, an estate's assets will be treated as situated in the United States if they are so treated under U.S. domestic law. However, if enacted, a technical correction now pending before the Congress will amend U.S. domestic law to clarify that assets will not be treated as U.S. situs assets for purposes of the pro rata unified credit computation if the United States is precluded from taxing them by reason of a treaty obligation. This technical correction will affect the interpretation of both this paragraph 2 and the analogous provisions in existing conventions. As currently proposed, it will take effect on the date of enactment.

Paragraph 2 restricts the availability of the pro rata unified credit in two respects. First, the amount of the unified credit otherwise allowable under paragraph 2 is reduced by the amount of any unified credit previously allowed against U.S. gift tax imposed on any gift by the decedent. This rule reflects the fact that, under U.S. domestic law, a U.S. citizen or U.S. resident individual is allowed a unified credit against the U.S. gift tax on lifetime transfers. However, as a result of the estate tax computation, the individual is entitled only to a total unified credit of $192,800, and the amount of the unified credit available for use against U.S. estate tax on the individual's estate is effectively reduced by the amount of any unified credit that has been allowed in respect of gifts by the individual. This rule is reflected by reducing the amount of the pro rata unified credit otherwise allowed to the estate of a decedent individual under paragraph 2 by the amount of any unified credit previously allowed with respect to lifetime gifts by that individual. This reduction will be relevant only in rare cases, where the decedent made gifts subject to the U.S. gift tax while a U.S. citizen or U.S. resident (as defined under the Internal Revenue Code for U.S. gift tax purposes).

Paragraph 2 also conditions allowance of the pro rata unified credit upon the provision of all information necessary to verify and compute the credit. Thus, for example, the estate's representatives will be required to demonstrate satisfactorily both the value of the worldwide estate and the value of the U.S. portion of the estate. Substantiation requirements also apply, of course, with respect to other provisions of the Protocol and the Convention. However, the negotiators believed it advisable

to emphasize the substantiation requirements in connection with this provision, because the computation of the pro rata unified credit involves certain information not otherwise relevant for U.S. estate tax purposes.

In addition, the amount of the pro rata unified credit is limited to the amount of U.S. estate tax imposed on the estate. See section 2102(c)(4) of the Internal Revenue Code.

Marital credit.

Paragraph 3 of Article XXIX B allows a special "marital credit" against U.S. estate tax in respect of certain transfers to a surviving spouse. The purpose of this marital credit is to alleviate, in appropriate cases, the impact of the estate tax marital deduction restrictions enacted by the Congress in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). It is the firm position of the U.S. Treasury Department that the TAMRA provisions do not violate the non-discrimination provisions of this Convention or any other convention to which the United States is a party. This is because the estate--not the surviving spouse--is the taxpayer, and the TAMRA provisions treat the estates of nonresidents not citizens of the United States in the same manner as the estates of U.S. citizen and U.S. resident decedents. However, the U.S. negotiators believed that it was not inappropriate, in the context of the Protocol, to ease the impact of those TAMRA provisions upon certain estates of limited value.

Paragraph 3 allows a non-refundable marital credit in addition to the pro rata unified credit allowed under paragraph 2 (or, in the case of a U.S. citizen or U.S. resident decedent, the unified credit allowed under U.S. domestic law). However, the marital credit is allowed only in connection with transfers satisfying each of the five conditions set forth in paragraph 3. First, the property must be "qualifying property," i.e., it must pass to the surviving spouse (within the meaning of U.S. domestic law) and be property that would have qualified for the estate tax marital deduction under U.S. domestic law if the surviving spouse had been a U.S. citizen and all applicable elections specified by U.S. domestic law had been properly made. Second, the decedent must have been, at the time of death, either a resident of Canada or the United States or a citizen of the United States. Third, the surviving spouse must have been, at the time of the decedent's death, a resident of either Canada or the United States. Fourth, if both the decedent and the surviving spouse were residents of the United States at the time of the decedent's death, at least one of them must have been a citizen of Canada. Finally, to limit the benefits of paragraph 3 to relatively small estates, the executor of the decedent's estate is required to elect the benefits of paragraph 3, and to waive irrevocably the benefits of any estate tax marital deduction that would be

allowed under U.S. domestic law, on a U.S. Federal estate tax return filed by the deadline for making a qualified domestic trust election under Internal Revenue Code section 2056A(d). In the case of the estate of a decedent for which the U.S. Federal estate tax return is filed on or before the date on which this Protocol enters into force, this election and waiver must be made on any return filed to claim a refund pursuant to the special effective date applicable to such estates (discussed below).

Paragraph 4 governs the computation of the marital credit allowed under paragraph 3. It provides that the amount of the marital credit shall equal the lesser of (i) the amount of the unified credit allowed to the estate under paragraph 2 or, where applicable, under U.S. domestic law (before reduction for any gift tax unified credit), or (ii) the amount of U.S. estate tax that would otherwise be imposed on the transfer of qualifying property to the surviving spouse. For this purpose, the amount of U.S. estate tax that would otherwise be imposed on the transfer of qualifying property equals the amount by which (i) the estate tax (before allowable credits) that would be imposed if that property were included in computing the taxable estate exceeds (ii) the estate tax (before allowable credits) that would be imposed if the property were not so included. Property that, by reason of the provisions of paragraph 8 of this Article, is not subject to U.S. estate tax is not taken into account for purposes of this hypothetical computation.

Finally, paragraph 4 provides taxpayers with an ordering rule. The rule states that, solely for purposes of determining any other credits (e.g., the credits for foreign and state death taxes) that may be allowed under U.S. domestic law to the estate, the marital credit shall be allowed after such other credits.

In certain cases, the provisions of paragraphs 3 and 4 may affect the U.S. estate taxation of a trust that would meet the requirements for a qualified terminable interest property ("QTIP") election, for example, a trust with a life income interest for the surviving spouse and a remainder interest for other family members. If, in lieu of making the QTIP election and the qualified domestic trust election, the decedent's executor makes the election described in paragraph 3(d) of this Article, the provisions of Internal Revenue Code sections 2044 (regarding inclusion in the estate of the second spouse of certain property for which the marital deduction was previously allowed), 2056A (regarding qualified domestic trusts), and 2519 (regarding dispositions of certain life estates) will not apply. To obtain this treatment, however, the executor is required, under paragraph 3, to irrevocably waive the benefit of any marital deduction allowable under the Internal Revenue Code with respect to the trust.

The following examples illustrate the operation of the marital credit and its interaction with other credits. Unless otherwise stated, assume for purposes of illustration that H, the decedent, and W, his surviving spouse, are Canadian citizens resident in Canada at the time of the decedent's death. Assume further that all conditions set forth in paragraphs 2 and 3 of this Article XXIX B are satisfied (including the condition that the executor waive the estate tax marital deduction), that no deductions are available under the Internal Revenue Code in computing the U.S. estate tax liability, and that there are no adjusted taxable gifts within the meaning of Internal Revenue Code section 2001(b) or 2101(c). Also assume that the applicable U.S. domestic estate and gift tax laws are those that were in effect on the date the Protocol was signed.

Example 1. H has a worldwide gross estate of $1,200,000. He bequeaths U.S. real property worth $600,000 to W. The remainder of H's estate consists of Canadian situs property. H's estate would be entitled to a pro rata unified credit of $96,400 (= $192,800 x (600,000/1,200,000)) and to a marital credit in the same amount (the lesser of the unified credit allowed ($96,400) and the U.S. estate tax that would otherwise be imposed on the property transferred to W ($192,800 [tax on U.S. taxable estate of $600,000])). The pro rata unified credit and the marital credit combined would eliminate all U.S. estate tax with respect to the property transferred to W.

Example 2. H has a worldwide gross estate of $1,200,000, all of which is situated in the United States. He bequeaths U.S. real property worth $600,000 to W and U.S. real property worth $600,000 to a child, C. H's estate would be entitled to a pro rata unified credit of $192,800 (= $192,800 x 1,200,000/1,200,000) and to a marital credit of $192,800 (the lesser of the unified credit ($192,800) and the U.S. estate tax that would otherwise be imposed on the property transferred to W ($235,000, i.e., $427,800 [tax on U.S. taxable estate of $1,200,000] less $192,800 [tax on U.S. taxable estate of $600,000])). This would reduce the estate's total U.S. estate tax liability of $427,800 by $385,600.

Example 3. H has a worldwide gross estate of $700,000, of which $500,000 is real property situated in the United States. H bequeaths U.S. real property valued at $100,000 to W. The remainder of H's gross estate, consisting of U.S. and Canadian situs real property, is bequeathed to H's child, C. H's estate would be entitled to a pro rata unified credit of $137,714 ($192,800 x $500,000/$700,000). In addition, H's estate would be entitled to a marital credit of $34,000, which equals the lesser of the unified credit ($137,714) and $34,000 (the U.S. estate tax that

would otherwise be imposed on the property transferred to W before allowance of any credits, i.e., $155,800 [tax on U.S. taxable estate of $500,000] less $121,800 [tax on U.S. taxable estate of $400,000]).

Example 4. H has a worldwide gross estate of $5,000,000, $2,000,000 of which consists of U.S. real property situated in State X. State X imposes a state death tax equal to the federal credit allowed under Internal Revenue Code section 2011. H bequeaths U.S. situs real property worth $1,000,000 to W and U.S. situs real property worth $1,000,000 to his child, C. The remainder of H's estate ($3,000,000) consists of Canadian situs property passing to C. H's estate would be entitled to a pro rata unified credit of $77,120 ($192,800 x $2,000,000/$5,000,000). H's estate would be entitled to a state death tax credit under Internal Revenue Code section 2102 of $99,600 (determined under Internal Revenue Code section 2011(b) with respect to an adjusted taxable estate of $1,940,000). H's estate also would be entitled to a marital credit of $77,120, which equals the lesser of the unified credit ($77,120) and $435,000 (the U.S. estate tax that would otherwise be imposed on the property transferred to W before allowance of any credits, i.e., $780,000 [tax on U.S. taxable estate of $2,000,000] less $345,800 [tax on U.S. taxable estate of $1,000,000]).

Example 5. The facts are the same as in Example 4, except that H and W are Canadian citizens who are resident in the United States at the time of H's death. Canadian Federal and provincial income taxes totalling $500,000 are imposed by reason of H's death. H's estate would be entitled to a unified credit of $192,800 and to a state death tax credit of $300,880 under Internal Revenue Code sections 2010 and 2011(b), respectively. Under paragraph 6 of Article XXIX B, H's estate would be entitled to a credit for the Canadian income tax imposed by reason of death, equal to the lesser of $500,000 (the Canadian taxes paid) or $1,138,272 ($2,390,800 (tax on $5,000,000 taxable estate) less total of unified and state death tax credits ($493,680) x $3,000,000/$5,000,000). H's estate also would be entitled to a marital credit of $192,800, which equals the lesser of the unified credit ($192,800) and $550,000 (the U.S. estate tax that would otherwise be imposed on the property transferred to W before allowance of any credits, i.e., $2,390,800 [tax on U.S. taxable estate of $5,000,000] less $1,840,800 [tax on U.S. taxable estate of $4,000,000]).

Canadian treatment of certain transfers.

The provisions of paragraph 5 relate to the operation of Canadian law. They are intended to provide deferral ("rollover") of the Canadian tax at death for certain transfers to a surviving

spouse and to permit the Canadian competent authority to allow such deferral for certain transfers to a trust. For example, they would enable the competent authority to treat a trust that is a qualified domestic trust for U.S. estate tax purposes as a Canadian spousal trust as well for purposes of certain provisions of Canadian tax law and of the Convention. These provisions do not affect U.S. domestic law regarding qualified domestic trusts. Nor do they affect the status of U.S. resident individuals for any other purpose.

Credit for U.S. taxes.

Under paragraph 6, Canada agrees to give Canadian residents and Canadian resident spousal trusts (or trusts treated as such by virtue of paragraph 5) a deduction from tax (i.e., a credit) for U.S. Federal or state estate or inheritance taxes imposed on U.S. situs property of the decedent or the trust. This credit is allowed against the income tax imposed by Canada, in an amount computed in accordance with subparagraph 6(a) or 6(b).

Subparagraph 6(a) covers the first set of cases--where the U.S. tax is imposed upon a decedent's death. Subparagraph 6(a)(i) allows a credit for U.S. tax against the total amount of Canadian income tax payable by the decedent in the taxable year of death on any income, profits, or gains arising in the United States (within the meaning of paragraph 3 of Article XXIV (Elimination of Double Taxation)). For purposes of subparagraph 6(a)(i), income, profits, or gains arising in the United States within the meaning of paragraph 3 of Article XXIV include gains deemed realized at death on U.S. situs real property and on personal property forming part of the business property of a U.S. permanent establishment or fixed base. (As explained below, these are the only types of property on which the United States may impose its estate tax if the estate is worth $1.2 million or less.) Income, profits, or gains arising in the United States also include income and profits earned by the decedent during the taxable year of death, to the extent that the United States may tax such amounts under the Convention (e.g., dividends received from a U.S. corporation and wages from the performance of personal services in the United States).

Where the value of the decedent's entire gross estate exceeds $1.2 million, subparagraph 6(a)(ii) allows a credit against the Canadian income tax on any income, profits, or gains from any U.S. situs property, in addition to any credit allowed by subparagraph 6(a)(i). This provision is broader in scope than is the general rule under subparagraph 6(a)(i), because the United States has retained the right to impose its estate tax on all types of property in the case of larger estates.

Subparagraph 6(b) provides rules for a second category of cases--where the U.S. tax is imposed upon the death of the

surviving spouse. In these cases, Canada agrees to allow a credit against the Canadian tax payable by a trust for its taxable year during which the surviving spouse dies on any income, profits, or gains (i) arising in the United States on U.S. situs real property or business property, or (ii) from property situated in the United States. These rules are intended to provide a credit for taxes imposed as a result of the death of the surviving spouse in situations involving trusts. To the extent that taxes are imposed on the estate of the surviving spouse, subparagraph 6(a) would apply as well. In addition, the competent authorities are authorized to provide relief from double taxation in certain additional circumstances involving trusts, as described above in connection with Article 14 of the Protocol.

The credit allowed under paragraph 6 is subject to certain conditions. First, where the decedent was a U.S. citizen or former citizen (described in paragraph 2 of Article XXIX (Miscellaneous Rules)), paragraph 6 does not obligate Canada to provide a credit for U.S. taxes in excess of the amount of U.S. taxes that would have been payable if the decedent had not been a U.S. citizen or former citizen. Second, the credit allowed under paragraph 6 will be computed after taking into account any deduction for U.S. income tax provided under paragraph 2(a), 4(a), or 5(b) of Article XXIV (Elimination of Double Taxation). This clarifies that no double credit will be allowed for any amount and provides an ordering rule. Finally, because Canadian domestic law does not contain a definition of U.S. situs property for death tax purposes, such a definition is provided for purposes of paragraph 6. To maximize coordination of the credit provisions, the Contracting States agreed to follow the U.S. estate tax law definition as in effect on the date of signature of the Protocol and, subject to competent authority agreement, as it may be amended in the future.

Credit for Canadian taxes.

Under paragraph 7, the United States agrees to allow a credit against U.S. Federal estate tax imposed on the estate of a U.S. resident or U.S. citizen decedent, or upon the death of a surviving spouse with respect to a qualified domestic trust created by such a decedent (or the decedent's executor or surviving spouse). The credit is allowed for Canadian Federal and provincial income taxes imposed at death with respect to property of the estate or trust that is situated outside of the United States. As in the case under paragraph 6, the competent authorities also are authorized to provide relief from double taxation in certain cases involving trusts (see discussion of Article 14, above).

The amount of the credit generally will be determined as though the income tax imposed by Canada were a creditable tax

under the U.S. estate tax provisions regarding credit for foreign death taxes, in accordance with the provisions and subject to the limitations of Internal Revenue Code section 2014. However, subparagraph 7(a) clarifies that a credit otherwise allowable under paragraph 7 will not be denied merely because of inconsistencies between U.S. and Canadian law regarding the identity of the taxpayer in the case of a particular taxable event. For example, the fact that the taxpayer is the decedent's estate for purposes of U.S. estate taxation and the decedent for purposes of Canadian income taxation will not prevent the allowance of a credit under paragraph 7 for Canadian income taxes imposed by reason of the death of the decedent.

In addition, subparagraph 7(c) clarifies that the credit against the U.S. estate tax generally may be claimed only to the extent that no credit or deduction is claimed for the same amount of Canadian tax in determining any other U.S. tax. This makes clear, for example, that a credit may not be claimed for the same amount under both this provision and Article XXIV (Elimination of Double Taxation). To prevent double taxation, an exception to this restriction is provided for certain taxes imposed with respect to qualified domestic trusts. Subject to the limitations of subparagraph 7(c), the taxpayer may choose between relief under Article XXIV, relief under this paragraph 7, or some combination of the two.

Relief for small estates.

Under paragraph 8, the United States agrees to limit the application of its estate tax in the case of certain small estates of Canadian resident decedents. This provision is intended to eliminate the "trap for the unwary" that exists for such decedents, in the absence of an estate tax convention between the United States and Canada. In the absence of sophisticated estate tax planning, such decedents may inadvertently subject their estates to U.S. estate tax liability by holding shares of U.S. corporate stock or other U.S. situs property. U.S. resident decedents are already protected in this regard by the provisions of Article XIII (Gains) of the present Convention, which prohibit Canada from imposing its income tax on gains deemed realized at death by U.S. residents on such property.

Paragraph 8 provides relief only in the case of Canadian resident decedents whose entire gross estates wherever situated (i.e., worldwide gross estates determined under U.S. law) have a value, at the time of death, not exceeding $1.2 million. Paragraph 8 provides that the United States may impose its estate tax upon property forming part of such estates only if any gain on alienation of the property would have been subject to U.S. income taxation under Article XIII (Gains). For estates with a total value not exceeding $1.2 million, this provision has the

effect of permitting the United States to impose its estate tax only on real property situated in the United States, within the meaning of Article XIII, and personal property forming part of the business property of a U.S. permanent establishment or fixed base.

Saving clause exceptions.

Certain provisions of Article XXIX B are included in the list of exceptions to the general "saving clause" of Article XXIX (Miscellaneous Rules), as amended by Article 17 of the Protocol. To the extent that an exception from the saving clause is provided for a provision, each Contracting State is required to allow the benefits of that provision to its residents (and, in the case of the United States, its citizens), notwithstanding the saving clause. General saving clause exceptions are provided for paragraphs 1, 5, and 6 of Article XXIX B. Saving clause exceptions are provided for paragraphs 2, 3, 4, and 7, except for the estates of former U.S. citizens referred to in paragraph 2 of Article XXIX.

Effective dates.

Article 21 of the Protocol contains special retrospective effective date provisions for paragraphs 2 through 8 of Article XXIX B and certain related provisions of the Protocol. Paragraphs 2 through 8 of Article XXIX B and the specified related provisions generally will take effect with respect to deaths occurring after the date on which the Protocol enters into force (i.e., the date on which the instruments of ratification are exchanged). However, the benefits of those provisions will also be available with respect to deaths occurring after November 10, 1988, provided that a claim for refund due as a result of these provisions is filed by the later of one year from the date on which the Protocol enters into force or the date on which the applicable period for filing such a claim expires under the domestic law of the Contracting State concerned. The general effective dates set forth in Article 21 of the Protocol otherwise apply.

It is unusual for the United States to agree to retrospective effective dates. In this case, however, the negotiators believed that retrospective application was not inappropriate, given the fact that the TAMRA provisions were the impetus for negotiation of the Protocol and that the negotiations commenced soon after the enactment of TAMRA. The United States has agreed to retrospective effective dates in certain other instances (e.g., in the case of the U.S.-Germany estate tax treaty). The retrospective effective dates apply reciprocally, so that they will benefit the estates of U.S. decedents as well as Canadian decedents.

Article 20

Article 20 of the Protocol does not amend the text of the Convention. It states two understandings between the Contracting States regarding future action relating to matters dealt with in the Protocol. Paragraph 1 requires the appropriate authorities of the Contracting States to consult on two matters within three years from the date on which the Protocol enters into force. First, they will consult with a view to agreeing to further reductions in withholding rates on dividends, interest and royalties under Articles X, XI, and XII, respectively. This provision reflects the fact that, although the Protocol does significantly reduce withholding rates, the United States remains interested in even greater reductions, to further open the capital markets and fulfill the objectives of the North American Free Trade Agreement. Second, the appropriate authorities of the Contracting States will consult about the rules in Article XXIX A (Limitation on Benefits). By that time, both Contracting States will have had an opportunity to observe the operation of the Article, and the United States will have had greater experience with the corresponding provisions in other recent U.S. tax conventions.

Paragraph 2 of Article 20 also requires consultations between the appropriate authorities, after the three-year period from the date on which the Protocol enters into force, to determine whether to implement the arbitration procedure provided for in paragraph 6 of Article XXVI (Mutual Agreement Procedure), added by Article 14 of the Protocol. The three-year period is intended to give the authorities an opportunity to consider how arbitration has functioned in other tax conventions, such as the U.S.-Germany Convention, before implementing it under this Convention.

Article 21

Article 21 of the Protocol provides the rules for the entry into force of the Protocol provisions. The Protocol will be subject to ratification according to the normal procedures in both Contracting States and instruments of ratification will be exchanged as soon as possible. Upon the exchange of instruments, the Protocol will enter into force.

Paragraph 2(a) of Article 21 generally governs the entry into force of the provisions of the Protocol for taxes withheld at source, while paragraph 2(b) generally governs for other taxes. Paragraphs 3, 4, and 5 provide special rules for certain provisions.

Paragraph 2(a) provides that the Protocol generally will have effect for taxes withheld at source on dividends, interest, royalties, and pensions and annuities (other than social security

benefits), under Articles X, XI, XII, and XVIII, respectively, with respect to amounts paid or credited on or after the first day of the second month following the date on which the Protocol enters into force (i.e., the date on which instruments of ratification are exchanged). However, with respect to direct investment dividends, the 5 percent rate specified in paragraph 2(a) of Article X will be phased in as follows: (1) for dividends paid or credited after the first day of the second month referred to above, and during 1995, the rate of withholding will be 7 percent; (2) for dividends paid or credited after the first day of the second month, and during 1996, the rate will be 6 percent; and (3) for dividends paid or credited after the first day of the second month and after 1996, the rate will be 5 percent.

For taxes other than those withheld at source and for the provisions of the Protocol relating to taxes withheld on social security benefits, the Protocol will have effect with respect to taxable years beginning on or after the first day of January following the date on which the Protocol enters into force. However, the rate of tax applicable to the branch tax under paragraph 6 of Article X (Dividends) will be phased in in a manner similar to the direct investment dividend withholding tax rate; that is, a rate of 6 percent will apply for taxable years beginning in 1996 and a rate of 5 percent will apply for taxable years beginning in 1997 and subsequent years.

Paragraph 3 of Article 21 provides a special effective date for the provisions of the new Article XXVI A (Assistance in Collection) of the Convention, introduced by Article 15 of the Protocol. Collection assistance may be granted by a Contracting State with respect to a request by the other Contracting State for a claim finally determined by the requesting State after the date that is ten years before the date of the entry into force of the Protocol. Thus, for example, if instruments of ratification are exchanged on July 1, 1995, assistance may be given by Canada under Article XXVI A for a claim that was finally determined in the United States at any time after July 1, 1985.

Paragraph 4 of Article 21 provides special effective date provisions for paragraphs 2 through 7 of the new Article XXIX B (Taxes Imposed by Reason of Death) of the Convention, introduced by Article 18 of the Protocol, and certain related provisions elsewhere in the Convention. These special effective date provisions are discussed above in connection with Article 18.

Finally, paragraph 5 of Article 21 provides a special effective date for paragraph 2 of Article 3 of the Protocol, which provides a new residence rule for certain "continued" corporations. Under paragraph 5, the new residence rule for such corporations will have effect for taxable years beginning on or after the first day of January following the date on which the Protocol enters into force.

DEPARTMENT OF THE TREASURY

TREASURY NEWS

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FOR IMMEDIATE RELEASE
JUNE 13, 1995

DEPUTY SECRETARY NEWMAN ANNOUNCES HE IS LEAVING TREASURY

Treasury Secretary Robert E. Rubin announced today that Deputy Secretary Frank Newman plans to leave the Treasury Department to return to the private sector.

In a letter today to President Clinton, Newman said his decision to leave was a difficult one, and he praised the President and Rubin for their leadership. Newman, in the letter, said he would be happy to stay for an appropriate amount of time to help with transition.

Secretary Rubin praised Newman for his service to Treasury and the country as both Deputy Secretary and in his previous capacity of Under Secretary for Domestic Finance.

"Frank has been an outstanding Deputy Secretary and Under Secretary," Rubin said. "His successes are many, including playing a pivotal role in both the passage of legislation for interstate banking and legislation for community development and the reduction of regulatory burden, as well as his leadership on the financial management functions of Treasury. His efforts as part of the President's Management Council have made the department work better and more efficiently. I and the rest of the department will miss him."

Newman was sworn in as Deputy Secretary on Sept. 29, 1994, after serving as Under Secretary since May 12, 1993.

"I have worked to contribute to the specific substantive accomplishments of your administration, as well as to the process of governing and managing the very broad range of activities of the Treasury Department," Newman wrote in his letter. "I will leave with a sense of pride in having been part of your administration's significant achievements for the good of the economy and the financial system."

He added, "While in many ways I am reluctant to leave the Treasury, I know that as an individual citizen, I will have great confidence in the exceptional abilities and judgment of Secretary Rubin, his policy and management team, and the professional Treasury staff."

RR-368 (MORE)

He represented Treasury on the President's Working Group on Financial Markets, which includes the chairs of the Federal Reserve Board, the Securities and Exchange Commission and the Commodities Futures Trading Commission. He was chairman of the Advanced Counterfeit Deterrence Steering Committee, and was a member of the President's Management Council, which is comprised of the Chief Operating Officer of each department and major executive branch agency.

Newman came to Treasury after six years with BankAmerica Corporation, where he was chief financial officer and vice chairman of the board of directors. Prior to joining BankAmerica in 1986, Newman spent 13 years with Wells Fargo Bank in San Francisco. He moved through the ranks at Wells Fargo to be named executive vice president and chief financial officer in 1980.

Prior to joining Wells Fargo in 1973, he was a vice president at Citicorp from 1969 to 1973 and a manager of the consulting firm of Peat Marwick, Livingston & Co. in Boston from 1966 to 1969.

-30-

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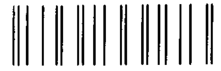
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